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In the Supreme Court of the United States

OCTOBER TERM, 1982

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRED L. AND MARY A. ENGLE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED

Section 613A of the Internal Revenue Code of 1954 allows a percentage depletion deduction to be computed with respect to the "average daily production of * * * oil * * * and * * * gas."

The question presented is whether respondents, who assigned oil and gas leases partly in consideration for advance royalties, are entitled to a depletion deduction against those advance royalties even though there was no production of oil or gas on the leased property during the year when they assigned the leases and received the advance royalties.

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRED L. AND MARY A. ENGLE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra*, 1a-15a) is reported at 677 F.2d 594. The opinion of the Tax Court (App. B, *infra*, 16a-56a) is reported at 76 T.C. 915.

JURISDICTION

The judgment of the court of appeals (App. C, *infra*, 57a) was entered on May 7, 1982. By order dated July 23, 1982, Justice Stevens extended the time within which a petition for a writ of certiorari could be filed to and including October 4, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

The pertinent parts of Sections 611, 613, and 613A of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in App. E, *infra*, 74a-78a.

STATEMENT

During 1975, respondent Fred Engle[1] acquired two oil and gas leases covering a total of 240 acres of land in Wyoming. Respondents assigned the leases to different parties in October 1975, and retained an overriding royalty in each case. As part of the consideration for the assignments, respondents received a total of $7,600 as advance royalties in 1975. This $7,600 was the only income respondents received from the properties in 1975. During that year, there was no discovery or exploratory work on the properties covered by the leases, and there was accordingly no oil or gas production on the properties (App. A, *infra*, 2a; App. B, *infra*, 17a-18a).

On their joint federal income tax return for 1975, respondents claimed a percentage depletion deduction equal to 22 percent of the $7,600 advance royalties they received (App. A, *infra*, 2a). On audit, the Commissioner of Internal Revenue disallowed the deduction. The Commissioner determined that respondents were not entitled to a percentage depletion deduction with respect to the $7,600 advance royalties, because there was no "average daily production" of oil or gas in 1975 as required by Section 613A(c) of the Internal Revenue Code of 1954 (App. E, *infra*, 76a-78a).

Respondents thereupon brought this proceeding in the Tax Court seeking a redetermination of the deficiency in their income tax arising as a result of the Commissioner's disallowance of their depletion deduction. In a reviewed decision with one dissent, the Tax Court upheld the Commissioner's determination (App. B, *infra*, 16a-56a). It first noted that under the pre-1975 law, a taxpayer could claim either cost or percentage depletion with regard to income

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[1] Fred Engle purchased the properties, but both respondents were parties to the assignments in October 1975 (App. A, *infra*, 15a)

realized from the property. Since the prior statutory allowance turned on the existence of income from the property, payments made without regard to actual production—such as advance royalties or lease bonuses—had been eligible for the percentage depletion allowance (App. B, *infra*, 19a). However, in 1975, Congress changed the rule. Pursuant to the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 *et seq.*, which added Section 613A to the Code, Congress generally eliminated the percentage depletion allowance for oil and gas wells. A narrow exception for domestic independent producers and royalty owners preserved the percentage depletion allowance, and tied the new oil and gas percentage depletion allowance to the existence of "average daily production." Since there had been no production of oil and gas on the properties covered by respondents' leases, the Tax Court ruled that respondents were not entitled to a percentage depletion allowance, but could claim only cost depletion (App. B, *infra*, 31a). As the Tax Court characterized the 1975 statutory amendment: "It is difficult to conceive what language Congress could have chosen to state more clearly a requirement tying the allowance of percentage depletion to the actual production of oil or gas on an annual basis" (App. B, *infra*, 30a; emphasis omitted).

The court of appeals reversed (App. A, *infra*, 1a-15a). After examining the statutory language, the court found the arguments of both parties to be "reasonable interpretations" and found "[t]he legislative history * * * [to be] of little help in resolving the statutory ambiguity" (*id.* at 11a). It nevertheless rejected the government's reliance upon the explicit statutory phrase "average daily production" as evidencing a requirement that there be actual extraction of oil during the taxable year for which the percentage depletion allowance is claimed. Instead, the court viewed Congress' desire to retain percentage depletion for "small producers" as equally persuasive of the matter. Hence, the court attributed to Congress the intent to retain the pre-1975 law with respect to advance royalties paid to small producers, and to permit percentage depletion as long as there is oil or gas produced at some point during the term of the lease. As the court stated: "Absent any clear

expression of Congressional intent, in either the statutory language or the attendant legislative history, to deny the percentage depletion allowance to taxpayers in [respondents'] situation, we conclude that 'production' cannot be read as a prerequisite to the deduction" (*ibid.*).

REASONS FOR GRANTING THE PETITION

1. a. In holding that respondents were entitled to claim percentage depletion on advance royalties from oil and gas leases from which there had been no mineral production during the year the royalty was paid, the decision below conflicts with *Farmar* v. *United States*, No. 15-80T (Ct. Cl. Sept. 22, 1982) (App. D, *infra*, 58a-73a). There, the Court of Claims adopted precisely the opposite interpretation of Section 613A of the Internal Revenue Code of 1954, by concluding that the statute "regularly link[s] depletion directly to production during a taxable year" (App. D, *infra*, 65a). It therefore held that the recipient of a lease bonus—likewise paid without regard to mineral production—was not entitled to the percentage depletion allowance. Since the tax consequences flowing to both lessor and lessee are a significant aspect of the negotiation of oil and gas leases, it is important that the parties to these transactions understand with certainty what payments are eligible for the percentage depletion allowance. This Court should therefore resolve the conflict that now exists as to the proper tax treatment of such payments in oil and gas transactions to establish a uniform national rule for the benefit of the oil and gas industry and the Treasury alike.

b. While the Court of Claims in *Farmar* acknowledged that its "overall views do vary from those expressed by the [instant] case" (App. D, *infra*, 73a), it suggested that the ultimate holdings of the two cases "may not necessarily be inconsistent" (*ibid.*) because *Farmar* dealt with lease bonuses and the decision below dealt with advance royalties. To be sure, an advance royalty is usually recoupable if there is no later production, while a lease bonus can be retained by the recipient even if the well never produces any oil or gas. But this distinction between a lease bonus and an advance royalty has no relevance for tax purposes. Both

are payments made to a mineral lessee in advance of mineral production. Accordingly, a long line of decisions of this Court confirms that it has accorded identical tax treatment to both lease bonuses and advance royalties. See *Douglas* v. *Commissioner*, 322 U.S. 275, 280 (1944) ("Royalty or bonus payments in advance of actual extraction of minerals are, like sales after severance or royalty payments on actual production, gross income and not a recovery of capital"); *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1924) ("A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted"); *Murphy Oil Co.* v. *Burnet*, 287 U.S. 299, 302 (1932) ("A distinction between royalties and bonus * * * would deny the 'reasonable allowance for depletion' which the statute provides"). See also *Burnet* v. *Harmel*, 287 U.S. 103, 111-112 (1932).[2] The court below therefore properly acknowledged that "lease bonuses and advance royalties have been treated similarly for tax purposes" (App. A, *infra*, 8a). And in considering the rationale of the decision below, the Court of Claims correctly recognized that "[t]he court's theory strongly suggests, though the opinion does not hold, that the same rule applies to lease bonuses * * *" (App. A, *infra*, 63a). There is accordingly a conflict of decisions that warrants resolution by this Court.

c. Moreover, the question presented is of considerable importance to the administration of the revenue laws. We are advised by the Internal Revenue Service that there are presently 11 cases pending administratively involving advance royalties or lease bonuses with more than $2 million at stake, and 7 cases docketed in the Tax Court with more

[2] Compare *Clark* v. *United States*, 587 F.2d 465 (10th Cir. 1978), where the court refused to hold that cash bonuses were advance royalties. The decision arose under the 1928 statute, Act of May 10, 1928, ch. 517, Section 3, 45 Stat. 496, that taxed advance royalties paid to Oklahoma Indians. The court noted that the Act was passed prior to this Court's decisions in *Burnet* v. *Harmel*, *supra*, and *Murphy Oil Co.* v. *Burnet*, *supra*, at a time it was not settled law that bonuses and advance royalties would be taxed alike. 587 F.2d at 468. In cases involving non-Indians, the Tenth Circuit has treated advance royalties and lease bonuses alike. See *United States* v. *White*, 401 F.2d 610 (1968); *Commissioner* v. *Pickard*, 401 F.2d 615 (1968).

than $500,000 at issue. Moreover, the payment of advance royalties and lease bonuses is a common occurrence in oil and gas lease transactions. Hence, it is expected that the conflict of decisions will result in the filing of a substantial number of claims for refund. A resolution by this Court will put the matter to rest and avoid further inconclusive litigation.

2. Prior to the enactment of the Tax Reduction Act of 1975, which added Section 613A to the Internal Revenue Code, the lessor of a mineral interest in consideration for a bonus or advance royalty was entitled to a percentage depletion allowance against such payments, whether or not there was mineral production in the year of payment. *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). But the Tax Reduction Act of 1975 changed this law. It generally repealed the percentage depletion allowance for oil and gas, effective January 1, 1975. See Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 501(a) and (b)(1), 89 Stat. 47 and 53. Congress permitted a single exception to this repeal for independent domestic producers and royalty owners. Thus, Section 613A(c) of the Code provides that percentage depletion "shall be computed in accordance with section 613 [allowing percentage depletion] with respect to * * * so much of taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed a specified depletable quantity. Section 613A(c)(1)(A) and (B) (App. E, *infra*, 77a). The "average daily production" is determined by dividing the aggregate production by the number of days in the taxable year.

The plain language of the statute convincingly refutes the decision below. The text of Section 613A(c)(1)(A) itself makes it clear that actual production is a prerequisite to any depletion deduction for oil and gas. The statutory deduction is linked to "so much of the taxpayer's average daily production * * * as does not exceed the taxpayer's depletable oil quantity" (as set forth in Section 613A(c)(3)(B)). Where average daily production is zero, as here, the statutorily prescribed limitations (2,000 barrels for 1975; see App. E, *infra*, 78a) are obviously not exceeded, and multiplying any amount times zero equals

zero. Without resort to legislative history or any other secondary material, the decision below is thus demonstrably wrong.

Surely, Congress did not use the term "average daily production" inadvertently. That term occurs in many places throughout the new provision. Section 613A(c)(1) and (A) requires that the oil and gas percentage depletion allowance be computed "with respect to" "the taxpayer's average daily production" of domestic crude oil or natural gas. The allowable depletable quantities are then defined in terms of production levels, and the applicable depletion rate and allowance are based on production during the particular taxable year. See Sections 613A(c)(2), (3), (4), (5), (6), (7), (9) and (10). It is a reasonable inference that by using the term "production" in connection with the percentage depletion allowance, Congress intended to tie eligibility for that allowance to actual production during the taxable year. Indeed, the common meaning of "production" in connection with minerals denotes physical extraction. As the Court of Claims observed in reaching the opposite conclusion from the decision below: "The sheer fact is that, throughout § 613A(c) and (d), Congress repeatedly refers to 'production' of oil and gas, and frequently refers to said 'production' for or during the 'taxable year,' in a way appearing to suggest that actual extraction was in mind" (App. D, *infra*, 64a-65a). Accord: Bravenec, *Continued Availability of Percentage Depletion of Oil and Gas*, 23 Oil & Gas Tax Q. 204, 211 (1975).

3. Contrary to the reasoning of the decision below (App. A, *infra*, 15a), the fact that the foregoing statutory interpretation departs from the rule under prior law is not controlling. It is the very enactment of Section 613A in 1975 that radically changed the availability of and eligibility for percentage depletion. As the Court of Claims put it: "If the words of later legislation fit better with such a departure than they do with retention of prior law, new language should be accepted as written (if, as * * * is the case here, the legislative history does not indicate otherwise)" (App. D, *infra*, 65a).

To the extent that the legislative history sheds light on the question, it supports our submission that eligibility for percentage depletion requires actual production during the taxable years. Section 613A was first proposed in 1974 as part of H.R. 17488, 93d Cong., 2d Sess. That bill, which likewise eliminated percentage depletion for oil and gas, contained an exception for small producers, and allowed them percentage depletion "with respect to so much of [a taxpayer's] average daily production of domestic crude oil as does not exceed 3,000 barrels." H.R. 17488, 93d Cong., 2d Sess., § 112(a) (1974). In a committee report on that bill, the House Committee on Ways and Means explicitly stated that the so-called "small producers" exemption was to be applied to "gross income attributable to a proportion of actual production." H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 46 (1974). The Committee further stipulated that "a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions" (*ibid.*).

Although H.R. 17488 was never enacted into law, its provisions contain the general framework for the independent domestic producers exemption. It is apparent from the congressional debates on the final bill in 1975 (H.R. 2166, 94th Cong., 1st Sess.) that Congress was most concerned with the production of oil and gas. See 121 Cong. Rec. 4622-4652, 6903-6905, 7218-7229, 7238-7248, 7263-7308, 7772-7813, 8128-8129, 8860 (1975). Since the Committee Report on H.R. 17488 spelled out a production prerequisite for use of percentage depletion and the current statute follows the approach of the prior legislative proposal, the legislative history of H.R. 17488 represents some evidence that Congress intended actual extraction of the mineral during the taxable year to be a necessary element of the percentage depletion deduction. While the decision below gave no credit to the prior committee statement because it related to an earlier bill in an earlier Congress (App. A, *infra*, 8a-11a), the Court of Claims properly regarded it as entitled to "some weight" "[i]n the absence of any real contradictory history" as "the only significant reference to the

issue before us" (App. D, *infra*, 70a). Indeed, in an analogous context, this Court has ascribed significance to the subsequent enactment of provisions originally contained in rejected legislative proposals. See *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 246 n.4, 264 n.31, 265 n.33 (1945), and accompanying text.

4. Although it rejected the Commissioner's reading of Section 613A, the court below acknowledged that "both parties to this controversy [have advanced] * * * reasonable interpretations" (App. A, *infra*, 11a). But in such a case, "[t]he choice among reasonable interpretations is for the Commissioner not the courts." *National Mufflers Dealers Association* v. *United States*, 440 U.S. 472, 488 (1979). Here, the Commissioner promulgated his interpretation two years after the enactment of Section 613A. Pursuant to the proposed regulations, which the decision below implicitly invalidated, percentage depletion requires actual production during the taxable year and therefore only oil or gas produced during the year can be taken into account.[3] "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967).

[3] See Proposed Treasury Regulations on Income Tax (1954 Code), Section 1.613A-7(f)(1), 42 Fed. Reg. 24287 (1977) (to be codified at 10 C.F.R. Part 1) (proposed May 13, 1977). App. E, *infra*, 83a. Advance royalties and lease bonuses, while taken into account for purposes of Sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance under Section 613A. App. E, *infra*, 83a. See also Section 1.613A-3(a)(4), *Example 4*, 42 Fed. Reg. 24281 (1977). App. E, *infra*, 81a.

CONCLUSION

The petition for a writ of certiorari should be granted.[4]

Respectfully submitted.

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OCTOBER 1982

[4] We are advised by counsel for the plaintiff in *Farmar* that he is actively considering seeking certiorari well in advance of the expiration of the 90-day period on December 21, 1982. In that event, we would acquiesce in such a petition and suggest that the Court either consolidate the cases or hear them in tandem. We are serving a copy of this petition upon counsel for the plaintiff in *Farmar*.

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 81-2463

FRED L. AND MARY A. ENGLE,
PETITIONERS-APPELLANTS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Appeal from the United States Tax Court.

ARGUED FEBRUARY 16, 1982–DECIDED MAY 7, 1982

Before PELL, *Circuit Judge*, FAIRCHILD, *Senior Circuit Judge*, and BAUER, *Circuit Judge*.

PELL, *Circuit Judge*. Taxpayers Fred and Mary Engle appeal from a decision of the United States Tax Court upholding a determination by the Commissioner that they were not entitled to a percentage depletion allowance on two oil and gas leases for the year 1975. The Engles had received advance royalties as a result of their assigning the leases during the taxable year. No physical extraction of oil or gas from the depletable properties had occurred during 1975. The Tax Court held that 26 U.S.C. § 613A(c) (1976)[1]

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[1] Unless otherwise indicated, all statutory references in this opinion are to the Internal Revenue Act of 1954, as amended, codified at Title 26 of the United States Code.

permits the percentage depletion deduction only if there is some physical extraction of oil or gas during the taxable year.

The sole issue on appeal is whether the Tax Court correctly interpreted section 613A(c) to preclude a taxpayer otherwise entitled to the percentage depletion allowance from claiming the deduction if there was no physical extraction of oil or gas from the depletable properties during the year for which the percentage depletion allowance is claimed.

I. FACTS

The facts are undisputed. Fred and Mary Engle are husband and wife. They filed a joint federal income tax return for 1975. During that year, Fred Engle acquired two oil and gas leases covering a total of 240 acres of land in Wyoming. Both leases were assigned by Engle to different parties in October, 1975. Engle received advance royalties of $7,600 from the two assignments. This $7,600 was the only taxable income received from the properties during 1975. No discovery or exploratory work was done on the properties covered by the leases during the taxable year; no gas or oil was extracted from the properties that year.

The Engles claimed a 22% depletion deduction, pursuant to section 613A. The Commissioner determined that the Engles were not entitled to the deduction because there was no "average daily production." § 613A(c), of domestic crude oil or natural gas and no average daily secondary or tertiary production of domestic crude oil or natural gas during 1975. The Commissioner assessed a deficiency of $4,957.55.[2] A majority of the Tax Court upheld the Commissioner's interpretation in a majority and concurring opinion that together span forty-six pages.[3] Judge Fay strongly dissented from the conclusion that the "average

[2] The deficiency also reflects other items of adjustment to which the appellants have not taken exception.

[3] The Tax Court held that the appellants were entitled to a cost depletion allowance, *see* § 612. There is, however, no indication that the taxpayers ever claimed cost depletion.

daily production" language of section 613A(c) makes actual physical extraction of gas or oil a prerequisite to the percentage depletion deduction.

II. DISCUSSION

We note at the outset that the pertinent language of section 613A(c) has not previously been interpreted by a court of appeals. We must consider the statutory language, pertinent legislative history, and the judicial interpretation of the percentage depletion allowance as it existed prior to enactment of section 613A[4] in construing the challenged provision. We begin by setting forth the stautory scheme for percentage depletion allowances as it existed prior to enactment of the Tax Reduction Act of 1975, Pub. L. No. 94–12, 89 Stat. 26 (1975) (1975 Act).

A. Sections 611 and 613 of Title 26.

Prior to promulgation of the 1975 Act, percentage depletion allowances were governed solely by sections 611 and 613. Section 611(a) states, in relevant part, that "there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion . . ." § 611(a). Section 613, entitled "Percentage Depletion," states in part: "In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the *gross income from the property. . . .*" *§ 613(a) (emphasis added).*

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[4] The Government appears to contend that judicial interpretations of section 613, the statutory section governing percentage depletion prior to enactment of section 613A, are irrelevant to this appeal because of the impact of section 613A. We disagree. As discussed in more detail *infra*, section 613A(c)(1) requires computation in accordance with section 613. Further, we think that the prior statutory scheme is relevant to the extent that the current statutory language fails to evidence a clear intent on the part of Congress to effect a different result under the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975). *Cf. Helvering v. Morgan's, Inc.*, 293 U.S. 121, 126-27 (1934) (construing the phrase "taxable year" by reference, in part, to interpretation of the term under previous revenue laws).

The Supreme Court made clear that if the depletable properties resulted in gross income to the taxpayer, the percentage depletion allowance was applicable whether or not any physical extraction occurred during the taxable year. E.g., Herring v. Commissioner, 293 U.S. 322 (1934). The ruling in *Herring* was in response to the Commissioner's conclusion that section 214(a)(9) of the Revenue Act of 1926 contemplated actual production as a prerequisite to the percentage depletion allowance. The Commissioner had reasoned that no oil or gas well existed absent production and the statutory language permitted the "reasonable allowance for depletion" only "[i]n the case of mines, oil and gas wells ...." It is clear, therefore, that the Engles would have been entitled to the percentage depletion allowance on the basis of their advance royalties had this case arisen prior to promulgation of the 1975 Act.

It was also established, prior to the 1975 Act, that if *no* production of oil or gas occurred prior to cancellation of the lease, the taxpayer was required to restore the previously deducted depletion to income. *Douglas v. Commissioner*, 322 U.S. 275, 285 (1944); 26 C.F.R. §§ 1.612.3(a)(2) and (b)(2) (1981). As the Tax Court noted in the instant case, this rule constituted at least an implicit requirement of actual production of oil or gas at some point in time.

B. The 1975 Act.

The 1975 Act essentially eliminated the percentage depletion allowance in the case of oil and gas wells except as to certain domestic gas wells and independent producers and royalty owners. *See* §§ 613A(a), (b), and (c). The latter exception is the one relevant to this appeal. That subsection provides in part:

> (c) Exemption for Independent Producers and Royalty Owners—
>
> (1) In general.—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) So much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

§ 613A(c)(1).

A majority of the Tax Court reasoned that physical extraction during the taxable year is a prerequisite if the percentage depletion allowance is to be determined "with respect to . . . average daily production." The Tax Court also relied on language in two subsections which specify the tentative number of barrels in a taxpayer's "depletable oil quantity" and the applicable percentage to be used in computing the percentage depletion deduction. Each of these tables refers to "production during the calendar year." §§ 613A(c)(3) and (5). Because of this language, the Tax Court concluded that "the express language of section 613A(c) limiting the percentage depletion deduction to stated quantities of production is so clear that it permits no other reasonable interpretation" than that urged by the Commissioner.

In his brief before this court, the Commissioner argues that the term "production" means marketable oil or gas and, therefore, Congress clearly contemplated physical extraction in using that term. The Commissioner reasons that only if this extraction prerequisite is satisfied, should one refer to section 613(a). He concludes, as did the Tax Court, that the reference in section 613A(c) to "comput[ation] in accordance with section 613" was intended by Congress to incorporate into section 613A the numerous Regulations, Revenue Rulings and court opinions that had interpreted how the "gross income from the property" and the "taxable income from the property" were to be computed pursuant to section 613.

The appellants maintain, by contrast, that one must first look to section 613 and determine whether there is gross income from the depletable property. If there is, the percentage depletion allowance is available to the taxpayer regardless of whether physical extraction occurred during the year for which the deduction is claimed. The reference to "average daily production" in section 613A constitutes a *limitation* on the amount of deduction that a taxpayer may claim rather than a prerequisite.[5]

We will analyze this statutory language in Section II(d), *infra*, of this opinion. We do note at this time that, contrary to the conclusion stated by the Tax Court, we find the statutory language to be ambiguous. We therefore turn to the legislative history of the statute.

C. Legislative History.

An understanding of legislation before Congress in both 1974 and 1975 is necessary to determine the relevance of portions of the legislative history relied on by the parties.

During 1974, the House Committee on Ways and Means considered H.R. 17488. 93d Cong., 2d Sess. (1974). That bill generally repealed percentage depletion. It allowed

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[5] For instance, assume that during 1975 a depletable property produced 800,000 barrels of oil, none of which represented secondary or tertiary production. Section 613A(c)(3)(B) provides that the taxpayer would have a depletable oil quantity of 2,000 barrels. In order to determine the allowable percentage depletion, one would first establish the average daily production by dividing 800,000 by 365 days, § 613A(c)(2)(A), which results in approximately 2,190 barrels. This exceeds the depletable oil quantity of 2,000 barrels and, therefore, the taxpayer could claim the percentage depletion allowance under section 613A(c)(1) with respect to only a portion of his actual production.

As the Tax Court noted, the "average daily production" language cannot state an absolute ceiling on quantities of production entitled to percentage depletion because other subsections prescribe specific rules for treatment of production in excess of the tentative barrel limitations stated in section 613A(c)(3)(B). *See* § 613A(c)(7). This does not, in our view, preclude the appellants' argument that the references to "average daily production" are intended to distinguish the production eligible for treatment under section 613A(c)(1) from that which is subject to the "special rules" of section 613A(c)(7).

three exemptions from the repeal including one for small producers.[6] The bill was reported out of Committee but no further action was taken on it. It was never reviewed by the Senate, the Finance Committee of the Senate, or the Joint Committee.

In 1975, H.R. 2166, 94th Cong., 1st Sess. (1975), was ordered reported to the House. There was *no* provision in the committee version of that bill eliminating percentage depletion on income from oil and gas wells.[7] A House floor amendment introduced repeal of percentage depletion into H.R. 2166. 121 Cong. Rec. 4651-4652 (1975). That amendment contained none of the exceptions that had been part of H.R. 17488. H.R. 2166 then went to the Senate where an exemption for independent royalty owners and producers was added. The Senate amendment differed from the exemption that had been contained in H.R. 17488 in several respects. For example, the Senate amendment allowed percentage depletion at a rate of 22% and with respect to an average daily production of 2,000 barrels whereas H.R. 17488 had provided for percentage depletion at the rate of 15% with respect to the first 3,000 barrels of production per day. The Conference Committee considered the Senate amendment, *see* H.R. Conf. Rep. No. 94-120, 94th Cong., 1st Sess. 6768, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 132-34 (Conference Committee Report), and modified it in some respects not relevant to the issue before this court. This amendment was later codified as Section 613A(c).

The only reports that discuss the retention of percentage depletion for independent producers and royalty owners are *H.R. 17488: Energy Tax and Individual Relief Act of 1974*, H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 46 (1974) (H.R. 17488 Report), and the Conference Committee Report cited above. As at least one commentator has noted, there is little record of meaningful Congressional debate on

[6] The exemptions for production from stripper wells and the North Slope of Alaska are irrelevant to the case at bar.

[7] The related report of the House Committee on Ways and Means, H.R. Rep. No. 94-19, 94th Cong., 1st Sess. (1975), makes no reference to percentage depletion.

the provisions that were codified as section 613A, largely because of the rush to pass the 1975 Act. Bavenic, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 Oil & Gas Tax Q. 204, 204 (1975).

The Government has relied heavily in its brief on the H.R. 17488 Report. Initially, we must assess whether that reliance is warranted. The report states in part: "[A] lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be in any of the exemptions." H.R. 17488 Report at 46. Because lease bonuses and advance royalties have been treated similarly for tax purposes, it is apparent that the above-quoted language would be relevant to this case had H.R. 17488 been enacted into law.

The commissioner argues that the H.R. 17488 Report is relevant to this case on the authority of *Helvering v. Morgan's, Inc.*, 293 U.S. 121 (1934), and *Helvering v. New York Trust Co.*, 292 U.S. 455 (1934). The *Morgan's* Court was construing the term "taxable year" as used in section 200(a) of the Revenue Act of 1926. That Court stated "the true meaning of a single section of a statute in a setting as complex as that of the revenue acts cannot be ascertained ... if the mind be isolated from the history of the income tax legislation of which it is an integral part." 293 U.S. at 126 (citation omitted). The *Morgan's* Court was not, however, discussing whether legislative history of a bill *never enacted* was relevant to its interpretation of section 200(a); rather, the Court referred to the rule established pursuant to earlier *enacted* revenue laws that "taxable year" related to a twelve-month accounting period of the taxpayer. Similarly, the references in *New York Trust Co.* to legislative intent cannot be read as mandating consideration of the legislative history of a bill that was never enacted.

The Commissioner has failed to provide persuasive precedent for his contention that the legislative history of H.R. 17488 is relevant to this appeal. We note that the Tax Court did not rely on the H.R. 17488 Report. We think that the legislative developments in 1974 and 1975 undercut the Commissioner's reliance on statements pertinent to H.R.

17488. In the Committee version of H.R. 2166, the House *retained* the percentage depletion rules as they then existed. This is the opposite position from that taken by the same Committee in H.R. 17488. It is extremely difficult, as a matter of common sense, to conclude from this pattern that the intent of the House in 1974 remained unchanged in 1975. Second, the Senate never considered H.R. 17488. Although the Senate was undoubtedly aware that H.R. 17488 had contained an exemption for independent producers and royalty owners, the Senate version of H.R. 2166 did not contain an exemption identical to that contained in H.R. 17488. On the basis of these facts, we cannot conclude that the intention of the House Ways and Means Committee in 1974 to abolish percentage depletion for advance royalties was necessarily shared by the legislators who eventually enacted H.R. 2166. We find, therefore, that remarks contained in the H.R. 17488 Report are of little, if any, relevance to the issue before us.

Turning to the scant legislative history that is relevant to the enacted legislation, the Government relies on the following passage:

> The conference substitute follows the Senate amendment in providing a small producer exemption from the repeal of percentage depletion for oil and gas. Initially the exemption ("depletable oil quantity") is 2,000 barrels of average daily production (or 12,000,000 cubic feet of natural gas).

Conference Committee Report at 68, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 133. The Government also quotes the statement by Representative Vanik that the Committee version of H.R. 2166 provided "a scheduled reduction in barrels of daily oil production eligible for 22 percent depletion which goes down to 1,000 barrels." 121 Cong. Rec. 8924 (1975). Finally, the Commissioner refers to statements made during Congressional debates which indicate that Congress was primarily concerned with encouraging further exploration of domestic oil and gas resources

at the time it enacted the 1975 Act.[8] This concern, in the appellee's view, compels the conclusion that Congress intended the percentage depletion deduction to be available only when physical extraction of gas or oil occurred.

The taxpayers also rely on several portions of the Conference Committee Report. First, they quote: "[T]he Senate amendment retains percentage depletion at 22 percent on a permanent basis for the small independent producer to the extent that his average daily production of oil does not exceed 2,000 barrels a day, or his average daily production of natural gas does not exceed 12,000,000 cubic feet." Conference Committee Report at 67, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 132. They reason that the word "retains" evidences a Congressional intent to leave undisturbed the body of prior law that premised percentage depletion on gross income regardless of physical extraction. Second, the appellants cite several portions of the Conference Committee Report which refer to the exemption as the "small producer exemption." *Id.* at 67-68, *reprinted in* [1975] U.S. Code Cong. & Ad. News 122, 133-34. In the taxpayers' view, this language supports their argument

[8] *E.g.*, 121 Cong. Rec. 4606 (1975) (remarks of Rep. Rhodes) ("I think we should all recall that one of the reasons for this bill being brought here with some haste is the fact that we have a shortage of domestic petroleum").

The Government also relies on language utilized by the Senate Committee on Finance when it considered certain technical changes in section 613A after enactment of the legislation:

> Under the other exception (the "small producer exemption"), percentage depletion is allowed for a limited amount of production from wells located within the United States. The amount of production eligible for percentage depletion is an average of 2,000 barrels per day (or its equivalent in cubic feet of gas) for 1975 and phases down to an average of 1,000 barrels per day (or its equivalent in cubic feet of gas) for 1980 and thereafter.

S. Rep. No. 94-938, 94th Cong., 2d Sess. 424 (1976). The Government maintains that this report is entitled to consideration as a "secondarily authoritative expression of expert opinion," citing *Bobsee Corp. v. United States*, 411 F.2d 231, 237 n.18 (5th Cir. 1975). We need not resolve what weight, if any, should be attributed to this quotation because we find it no more explicit as to Congressional intent than the language of the statute or the Conference Committee Report.

that the "average daily production" language of section 613A(c) states only a *limitation* on the quantity of production eligible for the percentage depletion allowance.

D. Analysis.

Looking first at the statutory language itself, we find the arguments presented by both parties to this controversy to be reasonable interpretations. As the Government asserts, section 613A(c) makes repeated reference to the term "average daily production." Further, the charts contained in subsections 613A(c)(3) and (5) suggest that Congress was focusing on actual production during the taxable year for which the depletion allowance was claimed.

On the other hand, it is equally clear that the overriding effect of section 613A is to limit the percentage depletion allowance in the case of oil and gas wells. Section 613A(c) makes an exception for "small producers." To that end, some specification of the quantity of oil or gas for small producer eligibility was necessary. Congress might well have chosen to articulate this limitation by reference to "average daily production." It is also true, as the appellants urge, that interpreting physical extraction to be a prerequisite could lead to absurd results. Pursuant to such an interpretation the Engles might have claimed the depletion allowance had one barrel of oil been produced from the leased properties during 1975. Further, the section 613 basis of calculation by reference to gross income is explicitly incorporated into section 613A by the provisions of both sections 613(d) and 613A(c). Nothing in the statutory language specifically supports the Tax Court's conclusion that Congress intended to incorporate only the methods of calculating "gross income from the property" and "taxable income from the property" while abandoning gross income as the basis of the deduction.

The legislative history is of little help in resolving the statutory ambiguity. A Congressional interest in furthering exploration of domestic sources of gas and oil is not inconsistent with applicability of the percentage depletion allowance to advance royalties. The established rule that deducted depletion must be restored to income if there is no

production of oil or gas prior to cancellation of the lease, *Douglas v. Commissioner*, 322 U.S. 275, 285 (1944), in itself provides an incentive to production.

The portions of the Conference Committee Report cited by the Government do little more than repeat, without clarifying, the statutory references to average daily production. We find nothing in the cited language that elucidates whether "average daily production" was intended as a prerequisite or merely as a limitation on the amount of production subject, without invocation of the "special rules" of section 613A(c)(7), to the percentage depletion allowance.

Similarly, we cannot find dispositive the Conference Committee's use of the word "retains." In light of the general repeal of the allowance in the case of oil and gas wells effected by section 613A, the section 613A(c) provision clearly does "retain" percentage depletion for small producers whether or not physical extraction is made a prerequisite.

Section 613A(c) not only fails to address clearly the situation at bar; its impact is similarly ambiguous whenever physical extraction and gross income resulting from that production occur in different taxable years. The lengthy dissent to the Tax Court opinion, written by Judge Fay, spends considerable time pointing out these problems. Without setting forth in detail his analysis, we do note one of the problems left unsolved by the statute. In the case of a taxpayer who had an "average daily production," as the Commissioner construes that term, of 100 barrels a day in 1980 but received no gross income from that production until 1981, the "prerequisite" of actual production in 1980 would be satisfied but calculation of the percentage depletion allowance for that year, based on gross income, appears impossible because the depletable properties produced no income during the taxable year.

Section 613A(c) provides no method for "converting" the barrels to income so as to enable the taxpayer to claim the deduction in 1980. If the allowance with respect to the 100 barrels average daily production is instead allowed in 1981, the result is at odds with the statutory language defining "average daily production" in terms of the taxable year,

§ 613A(c)(2), because the "production" occurred in 1980. Similarly, it becomes unclear whether the applicable depletable oil quantity, *see* § 613A(c)(3), should be that stated for 1980 or 1981 and what "applicable percentage," see § 613A(c)(5), should apply. Regulations proposed by the Treasury Department would allow the deduction in 1981 but no percentage depletion allowance in 1980 on these facts. Proposed Income Tax Regulations § 1.613A-3(a)(4)(7), 42 Fed. Reg. 24281 (May 3, 1977).[9] The obvious difficulty with this proposed regulation is that it is inconsistent with the language of section 613A(c) if "production" means literal physical extraction during the taxable year for which the allowance is claimed.[10]

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[9] Our attention has been called to no proposed regulation specifically addressing the applicable percentage depletion quantity and the applicable percentage in such a case. In his concurring opinion below, Judge Goffe seems to assume that the 1981 quantity and percentage would apply under the proposed regulations, a result with which he disagrees.

[10] The result urged by the Commissioner in this case, a denial of the percentage depletion deduction with respect to advance royalties, is specifically embodied in another of the proposed regulations. Section 1.613A-7(f)(1) states:

> For example, advanced royalties (to the extent that actual production during the taxable year is insufficient to earn such royalties) and lease bonuses, while taken into account for purposes of sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A(c).

Under section 1.613A-7(f)(1), the allowance is *denied* when income is received in a year prior to extraction. Under section 1.613A-3(a)(4)(7), discussed *supra*, the deduction is *allowed* when the situation is reversed and extraction occurs in a taxable year prior to the year in which income results from the production. This inconsistency in the treatment of "production" and "income" arising in different taxable years is not supported by any logic. The purported goal of increasing exploration of domestic sources of oil and gas is an insufficient explanation given that prior law included an incentive to actual production, the "recovery" of a deduction calculated on advance royalties that was not matched with production before the conclusion of the lease term.

In summary, we find little guidance in either the statutory language or the relevant legislative history as to whether Congress intended to eliminate the percentage depletion allowance for advance royalties.

CONCLUSION

In his concurring opinion, Judge Goffe states: "The majority opinion has, in my view, taken a mangled statute that is unattended by any germane or informative legislative history and has interpreted it by a direct and simple construction of one of the least ambiguous words in the statute: production." Insofar as the Tax Court concludes that "production" requires physical extraction, the construction is indeed straightforward. To conclude that production is a *prerequisite*, however, is a far less "simple" and far less justified interpretation.

The efforts of the Tax Court, as demonstrated by the length of its opinions, to settle on a reading of the statute that will permit consistent application were unsparing. As the hypothetical situation above illustrates, however, the result reached by the Tax Court does not resolve all the statutory ambiguities that pertain to receipt of income from the depletable properties in a different year from the year in which physical extraction occurs.

The reading urged by the taxpayers does not deny that physical extraction is inherent in the term "production." It differs from the Tax Court's interpretation in that it characterizes "average daily production" as a limitation rather than as a prerequisite. Admittedly, this reading of the statute does not clarify all the ambiguities inherent in section 613A(c). For instance, it does not resolve in what year the percentage depletion allowance should be taken if physical extraction occurs in a year *prior* to the receipt of related gross income.

We cannot reject the taxpayer's reading of the statute merely because it leaves unanswered questions. The interpretation of the Tax Court suffers the same defect. To the extent that the Treasury Department and the Tax Court *have* resolved these questions, they have done so by

starting with the conclusion that production is a prerequisite and construing other ambiguous portions of the statute so as not to conflict with that interpretation.

The reading of the statute endorsed by the Tax Court effects a drastic change from the prior law regarding the availability of percentage depletion allowances for advance royalties. There is no explicit statement in any of the pertinent legislative history that Congress intended to achieve such a result. By contrast, the interpretation of the statute urged by the taxpayers results in far less marked a change: section 613A(c) changes for formula for computing percentage depletion for those whose production exceeds the limitation that is stated in terms of "average daily production." This interpretation does not deny the deduction to an entire class of royalty owners.

Absent any clear expression of Congressional intent, in either the statutory language or the attendant legislative history, to deny the percentage depletion allowance to taxpayers in the Engles' situation, we conclude that "production" cannot be read as a prerequisite to the deduction. The judgment of the Tax Court therefore is

REVERSED.

A true Copy:
Teste:

Clerk of the United States Court
of Appeals for the Seventh Circuit

APPENDIX B

76 T.C. No. 78

UNITED STATES TAX COURT

FRED L. AND MARY A. ENGLE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 6219-79.
Filed June 8, 1981.

Petitioners made assignments in 1975 of two oil and gas leases held by them, retaining, however, overriding royalties of 4 percent from one lease and 5 percent from the other. As part of the consideration for the assignments, they received advance royalties totaling $7,600. There was no production of oil or gas from either of the leases during 1975.

Held: Under sec. 613A(c), I.R.C. 1954, petitioners are not entitled to deduct percentage depletion with respect to the advance royalties in 1975.

Thomas J. Donnelly, for the petitioners.

Robert M. Fowler, for the respondent.

OPINION

FEATHERSTON, *Judge:* Respondent determined a deficiency in the amount of $4,957.65 in petitioners' Federal income tax for 1975. Petitioners failed to take exception to certain items of adjustment; therefore, the only issue for decision is whether a percentage depletion deduction is allowable under section 613A[1] with respect to $7,600 that petitioners received in 1975, as advance royalties, under the terms of their assignment of two oil and gas leases.

[1] All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

All of the facts have been stipulated.

At the time the petition was filed, petitioners, who are husband and wife, were legal residents of Hartland, Wisconsin. They filed their joint Federal income tax return for 1975 with the Internal Revenue Service Center, Kansas City, Missouri.

Effective July 1, 1975, petitioner Fred L. Engle (Fred) procured an oil and gas lease covering 80 acres of land in Campbell County, Wyoming. On October 6, 1975, he assigned the lease to Getty Oil Company, retaining, however, a 5-percent overriding royalty.[2] As part of the consideration for the assignment, he received an advance royalty in the amount of $6,000.

Fred was also the lessee under an oil and gas lease, effective beginning September 2, 1975, covering 160 acres of land in Carbon County, Wyoming. On October 22, 1975, petitioners assigned this lease to Marshall & Winston, Inc.,[3]

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[2] The term "royalty," as used in the area of natural resources taxation, refers to a fractional interest in the "production" (i.e., extraction) of oil and gas or other minerals that is created by the owner (in fee) of the minerals. F. Burke and R. Bowhay, Income Taxation of Natural Resources, sec. 2.03 (1980); 1 L. Fiske, Federal Taxation of Oil and Gas Transactions, sec. 2.08 (1980 Rev.).

As stated in Income Taxation of Natural Resources, *supra* at sec. 2.05:

> An overriding royalty is similar to a royalty in that, for Federal tax purposes, each is a right to minerals in place that entitles its owner to a specified fraction of production, in kind or in value, and neither is burdened with the costs of development or operation. They differ in that an overriding royalty is created from the operating interest, and its term is co-extensive with that of the operating interest from which it was created.
>
> The overriding royalty may be carved out or retained. It is said to be carved out if the owner of the working interest assigns a right to a fractional share of production free and clear of development and operating expense. It is retained if the lessee assigns the working interest and retains a fractional share of production free of development and operating costs.

For convenience, we shall herein use the term royalty in a more general sense in referring to the advances that petitioners received on overriding royalties.

[3] Although only Fred had signed the lease as lessee, both petitioners executed the assignment to Marshall & Winston, Inc.

retaining a 4-percent overriding royalty. As part of the consideration for the assignment, they received an advance royalty in the amount of $1,600.

The amounts received as consideration for the assignments of the leases constituted the only taxable income from the described properties in 1975. There were no related expenses. Prior to the end of 1975, no discovery or exploratory work had been done on the properties covered by the leases, and no oil or gas had been produced from the properties. During 1975, petitioners had no average daily production of domestic crude oil or natural gas and no average daily secondary or tertiary production of domestic crude oil or natural gas, within the meaning of section 613A(c), quoted in footnote 8, *infra*, which provides a limited deduction for percentage depletion in the case of oil and gas wells.

Section 611(a) provides in part that, in the case of mineral deposits (including oil and gas wells), "there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion." In theory, this deduction is allowed in order to permit the holder of an "economic interest" in minerals in place to recover his capital investment in those minerals tax-free.[4] See sec. 1.611-1(b)(1), Income Tax Regs.; *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 602-603 (1946); *Palmer* v. *Bender*, 287 U.S. 511, 557-558 (1933). For purposes of computing the deduction, Congress has provided two different methods, cost depletion[5] and percentage depletion,[6] and, where a taxpayer is

[4] In practice, a taxpayer may be able to recover his investment several times over due to the allowance of percentage depletion, under secs. 613 and 613A, which will be discussed *infra*.

[5] SEC. 612. BASIS FOR COST DEPLETION.

> Except as otherwise provided in this subchapter, the basis on which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain upon the sale or other disposition of such property.

See sec. 1.611-2(a), Income Tax Regs.

[6] SEC. 613. PERCENTAGE DEPLETION.

> (a) General Rule.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for deple-

entitled to use either method, the method allowing the greater deduction for any given tax year must be used to compute depletion for that year. Secs. 1.611-1(a) and 1.613-1, Income Tax Regs.

Prior to 1975, it was well settled that the recipient of advance royalties (i.e., royalties paid in advance of the actual production of a mineral) under an oil and gas lease was entitled to compute depletion on the basis of both the cost method and the percentage method and to deduct the greater of the two amounts so computed. See, e.g., *Herring* v. *Commissioner*, 293 U.S. 322 (1934). Effective for taxable years beginning after December 31, 1974, however, the Tax Reduction Act of 1975, Pub. L. 94-12. 89 Stat. 26, added a new section, section 613A, and related provisions which, with certain exceptions, generally eliminated percentage depletion in the case of oil and gas wells.[7] One of the exceptions, on which petitioners rely, provides a limited exemption for independent producers and royalty

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tion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). * * * In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * *

But see sec. 613A regarding the percentage depletion allowance for oil and gas wells.

[7] SEC. 613A. LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS.

(a) General Rule.—Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613 [i.e., without regard to percentage depletion].

* * *

See also sec. 613(d), providing as follows:

(d) Denial of Percentage Depletion in Case of Oil and Gas Wells.—Except as provided in Section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section.

owners. Sec. 613A(c).[8] Under this exception, the deduction of percentage depletion continues to be permitted "with respect to * * * so much of the taxpayer's average daily

[8] Sec. 613A(c) provides in part as follows:

(c) Exemption for Independent Producers and Royalty Owners.—

(1) In general.—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) Average daily production.—For purposes of paragraph (1)—

(A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.

In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary or his delegate).

(3) Depletable oil quantity.—

(A) In general.—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

production" of domestic crude oil or natural gas as does not exceed the taxpayer's "depletable quantities" of crude oil and natural gas.

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) Phase-out table.—For purposes of subparagraph (A)—

In the case of production during the calendar year:	The tentative quantity in barrels is
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(4) Daily depletable natural gas quantity.—For purposes of paragraph (1), the depletable natural gas quantity of any taxpayer for any taxable year shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have this paragraph apply. The taxpayer's depletable oil quantity for any calendar year shall be reduced by the number of barrels with respect to which an election under this paragraph applies. Such election shall be made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

(5) Applicable percentage.—For purposes of paragraph (1)—

In the case of production during the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

• • •

A taxpayer's "average daily production" of domestic crude oil or natural gas is determined by dividing his aggregate production[9] during the taxable year by the number of days in such taxable year. Sec. 613A(c)(2)(A). Under section 613A(c)(3), the taxpayer's depletable oil quantity is equivalent to a specified "tentative quantity," stated in terms of a certain number of barrels of oil "production during the calendar year," reduced by the taxpayer's average daily secondary or tertiary production of domestic crude oil and natural gas[10] for the "taxable year."[11] The taxpayer's depletable natural gas quantity is equal to the number of barrels of his depletable oil quantity that he elects to convert to depletable natural gas quantity,[12] and the taxpayer's depletable oil quantity is reduced by the number of barrels for which he has made such an election.[13]

The number of barrels constituting the taxpayer's tentative depletable oil quantity is set forth in a "Phase-out table" in section 613A(c)(3)(B). The number of barrels in this table is gradually reduced in the case of "production during

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[9] In the case of a taxpayer holding a partial interest in the production of oil and gas from any property, his production for purposes of sec. 613A(c) is to be "determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property." Sec. 613A(c)(2)(B).

[10] Separate provisions are made for the allowance of percentage depletion on secondary or tertiary production of domestic crude oil and natural gas. See sec. 613A(c)(6).

[11] Under sec. 613A(c)(2), a taxpayer's average daily production is determined with reference to his aggregate production during the "taxable year." However, the phase-out table in sec. 613A(c)(3) prescribing the tentative number of barrels in the taxpayer's depletable oil quantity, as well as the table in sec. 613A(c)(5) specifying the percentage to be used in computing percentage depletion, is keyed to the "calendar year." Thus, if a taxpayer is on a fiscal year, "each portion of such taxable year which occurs during a single calendar year shall be treated as if it were a short taxable year." Sec. 613A(c)(10).

[12] Under sec. 613A(b), which is not pertinent here, certain domestic gas wells are exempt from the repeal of percentage depletion in the case of oil and gas. Natural gas that is exempt under sec. 613A(b) is not to be taken into account in determining a taxpayer's depletable natural gas quantity under sec. 613A(c). Sec. 613A(c)(11).

[13] For purposes of this election, 6,000 cubic feet of natural gas is equivalent to 1 barrel of oil. Sec. 613A(c)(4).

dar year" from 2,000 barrels in 1975 to 1,000 barrels in 1980 and thereafter. In this connection, section 613A(c)(5) sets forth a table of percentages that are applicable in computing the percentage depletion allowance in the case of "production during the calendar year." The percentage to be used gradually declines from 22 percent in 1975 to 15 percent in 1984 and thereafter.

Respondent, in this case and in proposed regulations under section 613A(c), has taken the position that the exemption for independent producers and royalty owners does not allow percentage depletion on advance royalties paid under an oil and gas lease except to the extent that they are earned or "recouped" through actual production of oil or gas during the taxable year in which the advance royalties are received.[14] In support of his position, respondent emphasizes the language in section 613A(c)(1) stating that the allowance for depletion under section 611 shall be computed in accordance with section 613 only "with respect to * * * so much of the taxpayer's average daily production" of domestic crude oil or natural gas as does not exceed the depletable oil and natural gas quantities specified in section 613A(c)(3) and (4). Respondent reasons that petitioners, having *no* "average daily production" of oil or natural gas for 1975, have nothing with respect to which percentage depletion may be computed in accordance with section 613.

Petitioners, on the other hand, emphasize that percentage depletion was allowable with respect to advance royalties prior to the enactment of section 613A, notwithstanding the absence of production of oil or gas during the year of receipt of such payments. They point out that the depletion allowance has always been "based on the *proceeds* derived from the property" and argue that, therefore, "no *quantity* of oil or gas is required for purposes of the calculation." Petitioners contend that the quantities of

[14] See sec. 1.613A-3(a)(4), examples 4 and 5, Prop. Income Tax Regs., 42 Fed. Reg. 24281 (1977). The proposed regulations provide that percentage depletion is allowable under sec. 613A(c) only with respect to gross income attributable to oil and gas produced in a prior or current taxable year. See sec. 1.613A-7(f), Prop. Income Tax Regs., 42 Fed. Reg. 24287 (1977).

production specified in section 613A(c) were simply intended to limit the applicability of the exemption for independent producers and royalty owners to those producers and royalty owners with production levels below the ceiling quantities and that prior law was to be retained in full with respect to that class of persons.[15] Thus, petitioners maintain that "zero [production] is within the limitation just as is one drop of oil or one cubic centimeter of natural gas" and that, therefore, they are entitled to compute percentage depletion on the advance royalties in 1975.

We hold that petitioners are not entitled to deduct in 1975, a year in which they had no production of oil or gas, percentage depletion computed with reference to their $7,600 in advance royalties. Petitioners may deduct only cost depletion with respect to that sum, and they have made no claim to such a deduction.

As petitioners point out, the amount of the percentage depletion allowance under section 613(a) was computed prior to the enactment of section 613A(c) on the basis of the "gross income from the property," without regard to quantities of production. Nevertheless, section 613A(c) now imposes limitations on the percentage depletion allowance in terms of quantities of production and, as we read it, permits the computation of percentage depletion only with respect to gross income attributable to what might be called an exempt quantity of crude oil or natural gas production. Therefore, unless gross income can be identified as

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[15] Petitioners rely heavily on the following portion of the Conference Committee Report on the Tax Reduction Act of 1975, Conf. Rept. No. 94-120, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 624, 629-630:

> *Senate amendment.*—Under the Senate amendment, the deduction for percentage depletion is generally eliminated with respect to oil and gas produced on or after January 1, 1975, with certain exceptions. These include the exceptions provided under the House bill. In addition, the Senate amendment *retains percentage depletion* at 22 percent on a permanent basis for the small independent producer to the extent that his average daily production of oil does not exceed 2,000 barrels a day, or his average daily production of natural gas does not exceed 12,000,000 cubic feet. Where the independent producer has both oil and natural gas production, the exemption must be allocated between the two types of production. [Emphasis added.]

attributable to an exempt quantity of production (which, of course, can hardly be done in the case of payments received in advance of production), the computation of percentage depletion is not permitted.

In our view, *the express language* of section 613A(c) limiting the percentage depletion deduction to stated quantities of production *is so clear* that it permits no other reasonable interpretation. Section 613A(c)(1) allows percentage depletion only with respect to a limited amount of the taxpayer's "average daily production." As previously noted, the taxpayer's "average daily production" is to be determined by dividing his aggregate production by the number of days in "the taxable year"; if there has been no aggregate production, there can be no "average daily production" and percentage depletion is not, therefore, allowable.

Further support for this conclusion is found in the table in section 613A(c) specifying the tentative number of barrels in a taxpayer's "depletable oil quantity" (to which the "depletable natural gas quantity" is keyed) and in the table specifying the declining applicable percentage to be used in computing the percentage depletion deduction. Both tables refer to "production during the calendar year." Sec. 613A(c)(3) and (5). Given this statutory language, we think it clear that percentege depletion is allowable under section 613A(c) in a taxable year only if oil or natural gas has been produced, and the amount of the deduction must be computed by reference to the taxpayer's "average daily production," the depletable oil and natural gas quantities, and the applicable rates set forth in section 613A(c)(5) for the calendar year of production.[16] Because petitioners had no "average daily production" in 1975, they are not entitled to percentage depletion with respect to the advance royalties of $7,600 received in that year.

Petitioners' position that section 613A(c) retains prior law for independent producers and royalty owners, "so long as the quantities applicable to the exemption are not exceeded," is without merit. Section 613A(c) does not impose

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[16] See footnote 11, *supra*.

a production ceiling for the purpose of distinguishing a class of taxpayers entitled to the benefits of the exemption from those who are not. Independent producers and royalty owners having average daily production in excess of the statutorily prescribed depletable oil or natural gas quantities *are* entitled to use percentage depletion. The effective rate per unit of oil or gas is modified for those who have production in excess of their depletable quantities,[17] see sec. 613A(c)(7);[18] but independent producers and royalty owners are not denied percentage depletion deductions merely because they have oil or gas production in excess of the depletable quantities. Only those persons who are

[17] In this connection, see and compare L. Bravenec, "Continued Availability of Percentage Depletion on Oil and Gas," 23 Oil and Gas Tax Quarterly 204, 215-216 (1974-1975), with T. Englebrecht and R. Hutchins, "Percentage Depletion Deductions for Oil and Gas Operations: A Review and Analysis," 56 Taxes 48, 54 (1978).

[18] Sec. 613A(c)(7) provides as follows:

(7) Special Rules.—

(A) Production of crude oil in excess of depletable oil quantity.—If the taxpayer's average daily production of domestic crude oil exceeds his depletable oil quantity, the allowance under paragraph (1)(A) with respect to oil produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613(a) for all of the taxpayer's oil produced from such property during the taxable year (computed as if section 613 applied to all of such production at the rate specified in paragraph (5) or (6), as the case may be) as his depletable oil quantity bears to the aggregate number of barrels representing the average daily production of domestic crude oil of the taxpayer for such year.

(B) Production of natural gas in excess of depletable natural gas quantity.—If the taxpayer's average daily production of domestic natural gas exceeds his depletable natural gas quantity, the allowance under paragraph (1)(B) with respect to natural gas produced during the taxable year from each property in the United States shall be that amount which bears the same ratio to the amount of depletion which would have been allowable under section 613(a) for all of the taxpayer's natural gas produced from such property during the taxable year (computed as if section 613 applied to all of such production at the rate specified in paragraph (5) or (6), as the case may be) as the amount of his depletable natural gas quantity in cubic feet bears to the aggregate number of cubic feet representing the average daily production of domestic natural gas of the taxpayer for such year.

* * *

"retailers" or refiners" (or persons related to "retailers" or "refiners"), as those terms are defined in section 613A(d), are excluded from the class of taxpayers entitled to the benefits of the exemption.

Nor does the language in the Conference Committee Report, quoted in footnote 15, *supra*, to the effect that the Senate version of the bill "retains percentage depletion" for the small independent producer, aid petitioners' cause. That language was clearly intended to refer to the fact that, under the Senate version, the 22-percent rate for percentage depletion was to be retained on a permanent basis in connection with the exemption for independent producers. It was not the Senate version of the bill, but a Conference substitute, that was enacted into law. The Conference Report makes it plain that, although the Conference substitute followed the Senate version by providing a limited exemption for independent producers,[19] the exemption was to be gradually phased down both in terms of the exempt quantity of production and the rate to be applied in computing percentage depletion. Conf. Rept. No. 94-120, 94th Cong., 1st Sess., 1975-1 C.B. 624, 630. The Conference Report does not, as petitioners urge, indicate that prior law was to be retained in full for a certain class of producers and royalty owners.[20]

Section 613A(c)(1) does state, however, that "the allowance for depletion under section 611 shall be computed *in accordance with section 613* [emphasis added]" with respect to so much of the taxpayer's average daily production of oil or gas as does not exceed his depletable quantities. Section

[19] The House version of the bill contained no exemption for independent producers and royalty owners.

[20] Aside from the Conference Report cited above, which itself does not adequately explain the complex provisions of sec. 613A(c), the legislative history is quite sketchy. Sec. 613A was introduced as a Senate floor amendment, and as a result the provision was not considered in either the House Report (H. Rept. No. 94-19, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 569) or the Senate Report (S. Rept. No. 94-36, 94th Cong., 1st Sess (1975), 1975-1 C.B. 590) on the bill leading to the Tax Reduction Act of 1975. Similarly, the substance of the debates with respect to the exemption for independent producers and royalty owners is of little assistance in interpreting the provisions of sec. 613A(c).

613(a)[21] provides that, in computing percentage depletion, the measure of the deduction is a specified percentage of the "gross income from the property." Further, section 613(a) provides that the allowance shall not exceed 50 percent of "the taxpayer's taxable income from the property (computed without allowance for depletion)."

A large body of law was developed under section 613(a) as to the meaning of "gross income from the property" in relation to oil and gas wells. Extensive regulations have been issued to define the phrase "taxable income from the property" as used in section 613.[22] That section, its predecessors, and the regulations have been the subject of numerous Revenue Rulings and court opinions on how the "gross income from the property" and "taxable income from the property" are to be computed.[23] We think the language in section 613A(c) to the effect that the percentage depletion allowed to indepedent producers and royalty owners "shall be computed in accordance with section 613" means simply that the computation is to *follow the principles already developed* for computing percentage depletion for oil and gas, subject, of course, to the provisions of section 613A. Thus, percentage depletion under section 613A(c) is to be computed with reference to the "gross income from the property" *attributable to* the exempt portion of a taxpayer's "average daily production," but the allowance is limited to 50 percent of the "taxable income from the property."

It is true that, as petitioners emphasize, the Supreme Court in *Herring* v. *Commissioner*, 193 U.S. 322, 328 (1934), rejected the contention that some production of oil or gas was a prerequisite to the allowance of percentage depletion on a lease bonus or advance royalty received upon the execution of an oil and gas lease. The basis for this holding was that bonuses and advance royalties are not capital gains but "payment[s] in advance for oil or gas to be

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[21] See footnote 6, *supra*.

[22] Sec. 1.613-5, Income Tax Regs.

[23] See the discussion entitled "Taxable Income from the Property for Depletion Purposes" in Miller's Oil and Gas Federal Income Taxation, ch. 10 at 145 (J. Houghton ed. 1980).

extracted, and * * * [are] therefore taxable income." *Herring* v. *Commissioner*, *supra* at 324. However, the statute there involved (the predecessor of section 613) made "gross income from the property," without qualification, the case for computing percentage depletion.[24] The Court did not have before it the subsequently enacted provisions of section 613A(c) allowing percentage depletion, as we have discussed above, only with respect to the exempt portion of a taxpayer's average daily production of crude oil or natural gas. Under section 613A(c), where there has been no production during the taxable year of receipt, percentage depletion is not allowable in that year with respect to advance royalties paid under an oil and gas lease.

Of course, *actual production* of oil or gas at some point in time has always been *an implicit requirement* of the allowance for depletion under either the cost or the percentage method.[25] However, we do not think, as petitioners appear to contend, that income from possible production in a future year will suffice for the purposes of section 613A(c). In effect, this would mean that "production" as used in section 613A(c) should be read to mean "sales of future production."[26] There is no legislative history or discernible legislative purpose that will support such a rewriting of the statutory language.

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[24] Even so, if there was no production of oil or gas prior to the cancellation of the lease (i.e., no actual depletion), the taxpayer was required to restore the previously deducted depletion to income. *Douglas* v. *Commissioner*, 322 U.S. 275, 285 (1944); *Sneed* v. *Commissioner*, 119 F.2d 767, 711 (5th Cir. 1941), affg. 40 B.T.A. 1136 (1939), cert. denied 314 U.S. 686 (1942).

[25] See footnote 24, *supra*, and sec. 1.612-3(a)(2) and (b)(2), Income Tax Regs.

[26] See M. Backus, "A Stitch in Time Necessary to Save Lease Bonus Depletion," 55 Taxes 313 (1977); L. Bravenec, "Continued Availability of Percentage Depletion on Oil and Gas," 23 Oil and Gas Tax Quarterly 204, 211 (1974-1975) (while contending that "production" as used in sec. 613A(c) should be interpreted as meaning "sales," the author notes that it "is difficult to sustain * * * [such a] construction by reference to the statutory language").

Section 613A(c) does not refer merely to production in general, but to a taxpayer's aggregate production "under the taxable year." In prescribing the depletable quantities, the section specifies a quantity of oil measured in "barrels" of "production during the calendar year" and a quantity of natural gas measured by reference to "barrels" of oil and "cubic feet" of gas. The section also makes important distinctions that depend on the type of production, i.e., oil versus natural gas, and the method of production, i.e., primary versus secondary or tertiary. Sec. 613A(c)(6) and (7). *It is difficult to conceive what language Congress could have chosen to state more clearly a requirement tying the allowance of percentage depletion to the actual production of oil or gas on an annual basis.*

Finally, numerous practical problems would arise in the application of section 613A(c) if production were interpreted to include royalties received in advance of production. When advance royalties are received upon the execution or assignment of a lease, the lessor may not know what mineral will be discovered or (in some cases) what method of recovery will be required to produce it. As appointed out above, the section prescribes different formulae for computing a taxpayer's "depletable oil quantity" and a taxpayer's "depletable natural gas quantity." Section 613A(c)(6) prescribes an entirely separate set of rules with respect to the allowance of percentage depletion on secondary and tertiary production. If a taxpayer has "excess production" during the taxable year, he must allocate the taxable income from the property between oil and gas production. Sec. 613A(c)(7). It should also be noted that section 613A(b)(2), as amended by the Energy Tax Act of 1978,[27] allows percentage depletion at the rate of 10 percent with respect to "any qualified natural gas from geopressured brine." Thus, if the term "production" as used in section 613A(c) is read so as to include income from the production of future years, there may be no way to determine at the time such income

[27] Pub. L. 95-618, 92 Stat. 3204 (Nov. 9, 1978). The amendment applies to natural gas produced from geopressured brine and "which is produced from any well the drilling of which began after September 30, 1978, and before January 1, 1984."

is received whether the section 613A(b) and (c) limitations on oil, gas, primary or (in some situations) secondary production, or natural gas from geopressured brine would apply.

In our view, the fact that section 613A(c) was written into the Internal Revenue Code as a limited exception to the general repeal of percentage depletion for oil and gas militates against giving that section an expansive and extraordinary interpretation. Given the language of the statute and the absence of any legislative history indicating that the statute does not mean what it says, percentage depletion may not be deducted except with respect to exempt quantities of production. In the case of royalties paid in advance of production, the statutes here applicable limit the taxpayer to a deduction for cost depletion.

To reflect the foregoing,

Decision will be entered for the respondent.[28]

Reviewed by the Court.

NIMS, *J.*, did not participate in the consideration or disposition of this case.

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[28] See *Glass* v. *Commissioner*, 75 T.C. ____ (1981), filed this day.

GOFFE, *J.*, concurring: I wholeheartedly concur, not only in the result, but also in the rationale of the majority opinion, which, contrary to the complaint in Judge Fay's dissent, clearly explains why percentage depletion is not allowable against advance royalties which are not attributable to actual, existing production. Though I am inclined to pinpoint some of the aspects of our discourse on the thorny problems posed by section 613A, Internal Revenue Code of 1954,[1] I am moved to write this concurrence primarily because the dissenting opinion by Judge Fay suffers greatly from flaws of construction and oversights in application.

The majority's recitation of the historical treatment of advance royalties for percentage depletion purposes, as well as its explanation of the basic provisions of section 613A, needs no elaboration. It is undisputed that, prior to the enactment of section 613A, percentage depletion was allowable on advance royalties received, whether they were to be recouped against future production or not. However, who can deny that the 1975 legislation drastically reduced allowable percentage depletion? By dint of the construction of the disallowance, it is now the exception, rather than the rule, when percentage depletion is allowable.

At the outset, it should be pointed out that the 1975 revision to the previously existing percentage depletion scheme is a drafting nightmare. The denial contained in the cross-referencing of section 613(d), the almost-total denial contained in section 613A(a), and the exemption contained in and the cross-referencing of section 613A(c)(1), combine to provide a maze through which we must now approach the percentage depletion deduction. Furthermore, the controlling statute, as amended, fails to directly address not only the issues before us, but also raises multiple collateral issues which we are not asked to decide in this case. It is doubtful whether even reasonable regulations, if such

[1] All section references are to the Internal Revenue Code of 1954, as amended.

regulations are forthcoming from the Commissioner, can completely unscramble the present version of this item of "legislative grace."

The majority opinion has, in my view, taken a mangled statute that is unattended by any germane or informative legislative history and has interpreted it by a direct and simple construction of one of the least ambiguous words in the statute: production. Repeated readings of sections 611, 612, 613, and 613A lead me to the conclusion that percentage depletion, to the extent allowable at all, can be obtained only with respect to a limited quantity of actual production (oil or gas extracted from the ground) per year. The year of extraction controls the number of barrels of production with respect to which percentage depletion is allowable (such must be the necessary implication of a yearly depletable oil quantity—see section 613A(c)(3)), and it is that same year that determines the appropriate percentage to be applied to such barrels (such is the logical implication of the columnar heading in section 613(c)(5) which states "In the case of production during the calendar year").

Judge Fay's dissenting opinion focuses almost entirely upon situations where extraction and payment for the extracted hydrocarbon occur in different taxable years. This is the exception rather than the commonplace situation. It is even more exceptional in the case of royalty owners than independent producers. Normally oil or gas is sold in the taxable year in which it is extracted and the matching of the income with the allowable percentage depletion is simple.

If, for some reason, payment for the hydrocarbon is received in a calendar year subsequent to the year of extraction, we must determine in which taxable year, if either, the taxpayer is entitled to percentage depletion. This question is answered in section 1.613A-3(a)(4), Example 7, Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 3, 1977) as follows:

Example (7). H, a calendar year taxpayer, owns a domestic oil well which produced 100,000 barrels of oil in 1975. The proceeds from the sale of 15,000 barrels of that production are not includible in H's income until 1976. The

15,000 barrels produced in 1975 are included in H's average daily production for 1976 and excluded from such production for 1975.

At first blush the example appears reasonable. It merely provides for tracing the income from the oil extracted and applying the barrels produced to the taxable year the income is received. Because of the two new major ingredients introduced into the allowable percentage depletion deduction by the 1975 amendment, I conclude that the method is not fair. The 1975 revision to the percentage depletion deduction established an annual limitation on the deduction which varies for different calendar years from 1975 to 1980 and it also specified a variable percentage allowable for different calendar years from 1980 to 1984. Because of these variables, it makes a substantial difference as to which taxable year one refers in allowing percentage depletion on hydrocarbon income derived from the sale of production extracted in an earlier taxable year.

The majority clearly holds that the intent of the statute is to allow the percentage depletion deduction for hydrocarbons "produced." *"Production" means extraction.* No one familiar with the "oil business" would seriously question such a definition of "production." Because the focus of the percentage depletion deduction is on production (or extraction), in my view that identification should be preserved if payment for the hydrocarbon fortuitously fails to coincide with extraction in the same calendar year. The barrel limitation expressed as average daily production in section 613A(c)(2) refers to the taxpayer's "production" for any taxable year; the phase-out table in section 613A(c)(3)(B) is headed "In the case of production *during* [emphasis added] the calendar year"; and in section 613A(c)(5) the heading for the applicable percentage for specified calendar years reads, "In the case of production *during* [emphasis added] the calendar year." Because these limitations (barrel limitation and percentage allowable) are unmistakably defined in terms of production during the year, the income from all qualifying production in that year should be subject to percentage depletion regardless of the year of payment for that production. I would apply that rationale to Example

(7) above by holding that the 15,000 barrels of oil produced in 1975 would be entitled to percentage depletion of 22 percent regardless of the percentage allowable in the year the oil is sold. If the years were instead 1980 (year of extraction) and 1981 (year of sale), I would allow 20 percent depletion on the 15,000 barrels rather than 18 percent.

As to the barrel limitation on the 15,000 barrels, I would also look to the year of extraction rather than a subsequent year of sale.

To illustrate this concept, let us assume that the taxpayer had 380,000 barrels of production in 1981 of which 25,000 barrels were not sold until 1982. I would allow no percentage depletion on the 25,000 barrels sold in 1982 because in the year of extraction the taxpayer exceeded the 365,000 barrel limitation.

Let us assume instead that the taxpayer had only 365,000 barrels of production in 1981, all of which were sold in 1981 except 30,000 barrels, which were sold in 1982. Assume further that in 1982 the taxpayer extracted 365,000 barrels. Because the oil extracted in 1981, including the 30,000 barrels sold in 1982, did not exceed the taxpayer's limitation of 365,000 barrels when extracted, he should be entitled to percentage depletion on the proceeds from the sale of such oil in 1982 and he should be allowed percentage depletion at the rate of 20 percent (allowable for 1981) rather than 18 percent (allowable for 1982).

Although I have referred, for the sake of clearity, to specific barrels being extracted in one year and sold in the next, I recognize that a literal tracing of barrels of oil (or cubic feet of gas) would present a record-keeping nightmare. However, such tracing is unnecessary. By taking a cue from normal first-in, first-out inventory accounting, it is fairly easy to devise a system whereby the appropriate percentage depletion allowable with respect to production extracted in a given taxable year and sold in a subsequent taxable year can be determined on the basis of the amount of extraction, the tentative quantity, and the applicable percentage for such taxable year. Any unsold production from a taxable year can be "inventoried," by recording not only the amount remaining unsold but also the appropriate

percentage by which the proceeds from the sale of such production will be multiplied when it is eventually sold to arrive at allowable percentage depletion. Working from the assumption that the first oil or gas sold in a taxable year is the oldest oil or gas in inventory, all of the allowable percentage depletion will eventually be matched with the proceeds from the sale of the production which qualified for percentage depletion.

The following example illustrates this procedure: assume extraction and sales of oil (at an assumed price of $10 per barrel) in these amounts for the calendar years 1981 through 1983:

	1981	*1982*	*1983*
Extraction (in barrels)	1,460,000	365,000	36,500
Sales (in barrels)	730,000	365,000	766,500
Sales (in dollars)	$7,300,000	$3,650,000	$7,665,000

We should note that, in reality, the percentage depletion limitations are not imposed by applying the applicable percentage to a limited amount of barrels (though that is the effect and basic concept of the scheme), but rather such limitations are imposed by reducing the percentage applied to *all* barrels. Sections 613(a), 613A(c)(1), (5) and (7). For purposes of this example, I will refer to this percentage which is actually applied to all production income (which percentage may be equal to or less than the relevant applicable percentage specified in section 613A(c)(5)) as the "percentage depletion fraction" (PDF).

According to section 613A(c)(1), if a taxpayer's average daily production (ADP) is less than or equal to his depletable oil quantity (DOQ), the PDF equals the applicable percentage (AP) set forth in section 613A(c)(5). If, however, a taxpayer's ADP is greater than his DOQ, his PDF equals the AP multiplied by a fraction the numerator of which is the DOQ and the denominator of which is the ADP. Thus, in our example, the PDF for each year is as follows:

	1981	1982	1983
ADP[a]	4,000	1,000	100
DOQ[b]	1,000	1,000	1,000
AP[c]	.20	.18	.16
PDF[d]	.05	.18	.16

a—APD = Total production divided by number of days in the taxable year. Sec. 613A(c)(2)(A).

1981 = 1,460,000 ÷ 365 = 4,000
1982 = 365,000 ÷ 365 = 1,000
1983 = 36,500 ÷ 365 = 100

b—Sec. 613A(c)(3).

c—Sec. 613A(c)(5).

d—Because ADP is greater than DOQ in 1981,

PDF = (DOQ ÷ ADP) x .20 = (1,000 ÷ 4000) x .20 = .05.

In 1982 and 1983, ADP is less than DOQ, so PDF = AP.

All oil extracted in those years should eventually be depleted at the PDF rate applicable to the year of such extraction, regardless of when sold. If that occurs, the total percentage depletion allowed would be as follows:

	1981	1982	1983	Total
Extraction	1,460,000	365,000	36,500	
Times Sales Price	x $10	x $10	x $10	
Gross Income	$14,600,000	$3,650,000	$365,000	
Times PDF	x .05	x .18	x .16	
TOTAL % DEPLETION	$ 730,00	$ 657,000	$ 58,400	$ 1,445,400

Mechanically, each year's percentage depletion deduction (assuming that the 50 percent of taxable income from the property limit is not exceeded) would be computed as follows:

1981—Total sales—730,000 barrels
PDF x (barrels sold x price per barrel)
.05 x (730,000 x $10)
.05 x $7,300,000
$365,000—1981 percentage depletion

Inventory (in barrels)—Beginning	-0-
Extracted[a]	1,460,000 @ .05
Subtotal	1,460,000 @ .05
Sold	(730,000 @ .05)
Ending	730,000 @ .05

1982—Total sales—365,000 barrels
PDF x (barrels sold x price per barrel)
.05 x (365,000 x $10)[b]
.05 x $3,650,000
$182,500—1982 percentage depletion

Inventory	—Beginning	730,000 @ .05
	Extracted	365,000 @ .18
	Subtotal	730,000 @ .05
		365,000 @ .18
	Sold	(365,000 @ .05)[b]
	Ending	365,000 @ .05
		365,000 @ .18

1983—Total sales—766,500 barrels
PDF x (barrels sold x price per barrel)
[.05 x (365,000 x $10)] + [.18 x (365,000 x $10)] + [.16 x (36,500 x $10)]
(.05 x $3,650,000) + (.18 x $3,650,000) + (.16 x $365,000)
$182,500 + 657,000 ;ol 58,400
$897,900—1983 percentage depletion

Inventory	—Beginning	365,000 @ .05
		365,000 @ .18
	Extracted	36,500 @ .16
	Subtotal	365,000 @ .05
		365,000 @ .18
		36,500 @ .16
	Sold	(365,000 @ .05)
		(365,000 @ .18)
		(36,500 @ .16)
	Ending	-0-

Thus the cycle is complete. Note that the total percentage depletion arrived at in these detailed calculations ($365,000 + $182,500 + $897,900 = $1,445,000) equals the amount calculated at the outset of this example, *supra* at page 8. No actual physical tracing of extraction is needed because this inventory-type method will accomplish the results sought by my interpretation of the statute. Some may quibble that the assumption of a constant price of oil invalidates this example. On the contrary, if prices rise or fall the above-outlined method will result in percentage

a—Must note the PDF previously calculated for production extracted that year.
b—Use FIFO to determine what barrels were sold, and, therefore, which PDF to use.

depletion calculated on the basis of the actual "gross income from the property" in the year the extraction is sold, which result dove-tails nicely with the general percentage depletion formula in section 613(a). The allowability, as well as the appropriate rate, of percentage depletion is determined as of the taxable year of extraction, as it should be.

Although I speculate as to whether the Commissioner may, by regulation, establish such a scheme when the statute does not specifically authorize it, the question apparently does not disturb the Commissioner because he has proposed, also without statutory mandate, his own brand of carryforward set forth above. That being the case, I would urge the commissioner, who has just prevailed in the instant case as to advance royalties and in *Glass v. Commissioner*, 76T.C. ____ (June 8, 1981), as to lease bonuses, to re-examine his proposed regulations (which have been proposed since 1977) in light of the opinions in these two cases in order to make them more compatible with the statute as amended in 1975. Surely our holdings in these two cases should encourage the Commissioner to re-examine the proposed regulations and attempt to finalize them in a form that correctly interprets the statute. Hope springs eternal that such an admonition will be heeded.

My proposal, which I contend is far from the characterization of "impossible" (dissenting opinion, *infra* at 50, fn. 6), easily conforms with the general requirements of section 613(a), a section which the dissent over and over ... and over ... abjures us not to neglect, that the deduction is allowable by taking a percentage of the gross income from the property.

Having said all this, it is easy to see the most glaring flaw in the analysis of the dissent. The statute requires a counting of the barrels of production in a taxable year in order to determine what production percentage depletion will be allowed "with respect to" and to determine the applicable percentage "in the case of production during the calendar year." Sec. 613A(c)(5). One cannot count barrels of production that do not yet, and may never, exist. When a taxpayer receives an advance royalty no one knows whether hydrocarbons will be extracted from that property. A

cursory examination of newspaper accounts of drilling activity readily demonstrates the folly of concluding that production will necessarily follow receipt of an advance royalty. As the majority points out so clearly on pages 23-26 of its opinion, the problems of statutory construction and obvious practical problems of imputing possible future production into a present-year calculation under new section 613A are insurmountable.

Similarly I, like the majority, am convinced that *Herring v. Commissioner*, 293 U.S. 322 (1934), provides little guidance here because of the drastic changes in the law made subsequent to that decision. No matter how many times the dissent proclaims that we are undermining the holding in *Herring*, the fact of the matter is that *Herring* simply does not apply. Just as the *Cohan* rule became largely irrelevant in the travel and entertainment expense context after the enactment of section 274, the *Herring* decision no longer holds complete sway in the percentage-depletion-on-advance-royalty context after the 1975 enactment of sections 613(d) and 613A.

The chant found throughout Judge Fay's dissenting opinion is that because section 613A(c)(1) provides that the allowance for depletion under section 611 "shall be computed in accordance with section 613," production has to have some relation to gross income. In such incantations, he continually states the obvious while overlooking the stated, i.e., that percentage depletion is now allowed only with respect to a limited amount of actual production. Of course, because percentage depletion is derived by multiplying gross income from the property by the applicable percentage, production must have some relation to gross income. Thus, only gross income attributable to the sale of so much of a taxpayer's average daily production as does not exceed his depletable quantity is now eligible for percentage depletion. The now-extant sections controlling this deduction do not speak to the timing of the deduction, except that section 613(a) requires that there be some gross income from the property in a taxable year as a necessary precondition to having something to multiply by the applicable percentage. Production limits the amount of the deduction; *ergo* in

order to compute the percentage depletion deduction for a taxable year, it is necessary to have had some actual production before or during such taxable year in order to qualify some barrels under section 613A(c), the proceeds from the sale of which constitute the gross income of which section 613(a) speaks. When the dissent starts from the above-stated proposition that production and income must be related, and reasons to the conclusion that hypothetical future production will somehow support a present percentage depletion deduction, it has engaged in a brand of deductive sophistry which I am loath to embrace.

Thus, I fully support the holding and rationale of the majority opinion. Though the author of that opinion did not need to extend its legal reasoning as far as I have in order to dispose of the issue before us, it is apparent that much of what I have outlined above is the necessary implication of the holding embodied in the majority opinion. Moreover, I agree that an alternative holding based upon a theory such as that found in the dissenting opinion would produce numerous practical problems, as outlined in the majority opinion at pages 24 and 25. The dissent's attempt to address these problems is feeble. (See dissenting opinion, *infra*, at p. 60 fn. 15). Since 6,000 cubic feet of gas may not sell for the same price as a barrel of oil, the need to know the make-up of the production is critical, particularly where there is "excess production." Secs. 613A(c)(7)(A) and (b). In addition, it will be the exception, rather than the rule, when a taxpayer knows, at the time an advance royalty or bonus is paid, whether secondary or tertiary recovery methods will be necessary or economically feasible. Furthermore, the dissent never addresses this obvious question: if an unrecouped advance royalty represents production in the year of receipt, how would one convert the raw dollar amount received into a quantity of barrels for purposes of determining the taxpayer's average daily production under section 613A(c)? How many dollars equal a barrel of oil, or, for that matter, 6,000 cubic feet of gas? The practical problem surely exists, even though the dissent does not, by reason of the small amount here involved, feel compelled to address it.

The dissent's strident examples prove nothing. Under the majority's approach, which has the virtue of interpreting the word "production" in its ordinary, everyday sense, *Malat v. Riddel*, 383 U.S. 569 (1966), the otherwise allowable percentage depletion on advance royalties recoupable against future production which are paid but not recouped in the year of payment will be lost forever. *Quaere* whether or not this is an inequitable result inasmuch as the taxpayer has received, in exchange for risking the loss of otherwise allowable percentage depletion, an advance royalty on production which may never exist.[2] Under the dissent's approach, the same inequitable result suggested by Example (7) of section 1.613A-3(a), Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 13, 1977), will occur, though for a slightly different reason (see discussion, *supra*). The proposed regulation would throw unsold, but otherwise allowable production, into the second year and include it in the average daily production computation, which treatment could produce an average daily production in excess of the allowable depletable quantity in the later year, resulting in partial permanent disallowance of percentage depletion, even though actual production in neither year exceeded the maximum depletable amount. Likewise, the dissent's approach would permanently deprive a similarly situated taxpayer of the same amount of depletion. By looking only at income, and then deriving from that amount the number of barrels represented, the dissent would say that all of the "production" occurred in the later year. Under an example where a taxpayer produced 365,000 barrels in 1981, 365,000 barrels in 1982, and sold all 730,000 barrels in 1982, the dissent's approach would conclude that the average daily production in 1982 is 2,000 barrels. Since the tentative quantity for 1982 is 1,000 barrels, this appraoch

[2] A similar result obtains, stresses the dissent, when production is sold prior to extraction. If, in such a highly improbable situation, the well is dry or blows out, and the seller must refund the sales proceeds, then such amounts are mere deposits. If the seller may keep the funds, again I wonder whether or not he has gotten the better end of the trade between money in hand and possible percentage depletion deductions.

would effectively deny percentage depletion on half of the production sold in 1982. Thus, whenever oil is stored from one year to the next (a not uncommon phenomenon for an independent producer), such oil, the proceeds from the sale of which would have been subject to percentage depletion had such oil been sold when extracted, quite likely will not be subject to percentage depletion when sold in a later year, and an extremely "harsh result obtains" (see dissent at pp. 51-52). It is apparent that examples can be marshalled to show the inequity of any construction of this statute. Thus, once again, I am content to follow the majority's simple, but not simplistic, interpretation of the term production.

I would like to turn briefly to other problems presented by the construction and application of sections 611 through 614.

It can hardly be denied that the rationale of the majority, when applied to the question of whether percentage depletion on lease bonuses remains available, requires a negative answer to such question. See *Glass v. Commissioner*, 76 T.C. ____ (June 8, 1981). Though percentage depletion was available to a lessor with respect to lease bonuses received prior to the 1975 change in the law, *Herring v. Commissioner*, *supra*, under the rationale of the majority here and under our decision this day in *Glass v. Commissioner*, *supra*, the diminution of the reservoir of hydrocarbons represented by the bonus payment is now recoverable only through the use of cost depletion.[3] That being the case, it is questionable whether there remains any reasonable need for the "bonus exhaustion rule" embodied in section 1.613-2(c)(5)(ii), Income Tax Regs. See also *Quintana Petroleum Co. v. Commissioner*, 143 F.2d 588 (5th Cir. 1944). The bonus exhaustion rule required that a lessee, in computing his "gross income from the property" (which is the amount to which the applicable percentage is applied in order to determine the allowable percentage depletion), exclude therefrom a proportionate part of any bonus paid

[3] In a wildcat area, the present treatment of bonuses received may be more advantageous than it would have been prior to 1975. See *Collums v. United States*, 480 F. Supp. 864 (D. Wyo. 1979).

with respect to such property on the theory that, because bonuses were characterized as advance royalties, to allow percentage depletion on both the bonus and on all of the production income from a property would result in double depletion on production income in an amount equal to the bonus paid. Inasmuch as bonuses are no longer subject to percentage depletion, the rationale for that rule no longer exists. See Bravenec & Flagg, "Initial Proposed Section 613A Regulations," 24 Oil & Gas Tax Q. 218, 224 (1975); Burke, "Proposed Regulations Under Section 613A—An Analysis and Critical Review," P-H Oil & Gas/Natural Resources (1976).[4] *Quaere* whether this rationale is also applicable to the unrecouped portion of advance royalties paid. See section 1.613-2(c)(5)(iii), Income Tax Regs.; Rev. Rul. 79-386, 1979-2 C.B. 246.

Another nettlesome problem arises when we consider the situation where a bonus, which is not subject to percentage depletion but should conceivably always be subject to cost depletion, is received in the same year as a royalty (or a recouped advance royalty), which royalty is subject to percentage depletion as limited by section 613A. At first blush, one would think that the recipient would just take cost depletion on the bonus (with regard only to the bonus) as outlined in section 1.612-3(a), Income Tax Regs., then calculate both cost and allowable percentage depletion on the royalty received and, pursuant to sections 1.611-1(a)(1), 1.612-3 (d), and 1.613-1, Income Tax Regs., deduct the greater of the two (subject to basis limitations for the deduction of cost depletion—sec. 1.611-2(b)(2), Income Tax Regs.). However, under my understanding of sections 1.611-1 (a) and 1.613-1, Income Tax Regs., as they presently exist, a taxpayer may deduct, with respect to each "property" (which is defined under section 614(a) as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land"), either cost or percentage depletion in the same taxable year, but

[4] It appears that the Commissioner still clings to the bonus exhaustion rule. See Rev. Rul. 79-73, 1979-1 C.B. 218; I.R.S. National Office Technical Advice Memorandum, written determination No. 8026011 dated March 20, 1980.

not both. Thus, a taxpayer in the above fact situation would be allowed to deduct (subject to section 1.611-2 (b)(2), Income Tax Regs.) only the greater of (1) an amount equal to the sum of cost depletion calculated with regard to the bonus under the formula set forth in section 1.612-3(a), Income Tax Regs., and cost depletion calculated under the formula set forth in section 1.611-2(a), Income Tax Regs., with regard to the royalty (or recouped advance royalty) received during that taxable year, or (2) an amount equal to the percentage depletion allowable under section 613A with respect only to the royalty (or recouped advance royalty) received during that taxable year. Compelling a choice between these two incomplete alternatives does not seem fair, and were I faced with a case requiring a construction of such regulations, I am not sure I could abide such an inequitable result. The controlling regulations were, of course, issued prior to the enactment of section 613A under the statutory mandate of section 611(a) that "there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * * such reasonable allowance in all cases to be made under regulations prescribed by the Secretary * * *." Though such regulations no doubt were reasonable prior to the enactment of section 613A, I question whether they continue to provide a "reasonable allowance for depletion" under the revised legislative scheme for calculating the percentage depletion deduction. I would hope that the Commissioner would promptly propose regulations that would allow a taxpayer to take cost depletion with respect to a bonus received, regardless of whether cost or percentage depletion is higher as to the income from actual production received during the same taxable year.

There are no doubt other technical problems in the percentage depletion area caused by the drastic revision made in 1975. The proposed regulations should be examined not only to resolve the problems I have enumerated above but also to speak to some other which lurk behind the scene. Hopefully the Commissioner will perform a comprehensive review of the proposed regulations.

FAY, *J.*, dissenting: While the grounds upon which the majority opinion rests its holding are unclear, I nevertheless disagree. In my view, advance payments for oil or gas do in fact represent "production" for purposes of section 613A(c).[1]

Section 613A(c)(1) allows percentage depletion with respect to so much of a taxpayer's "average daily production" as does not exceed his "depletable oil quantity." Section 613A(c)(2)(A) defines "average daily production" as "aggregate production" divided by the number of days in the taxable year. The critical word is "production." Unfortunately, the majority opinion makes no attempt to define "production" but cavalierly assumes there was no "production" in this case.[2] See majority, *supra* at 15. Evidently, the majority requires extraction but provides no enlightenment as to whether "production" means only extraction or whether extraction is merely one required element of "production."[3] While I agree that some tie to extraction is essential for percentage depletion, I see no reason why future extraction as well as past or current extraction cannot suffice. See generally, *Herring* v. *Commissioner*, 293 U.S. 322 (1934). I would interpret "production" to mean the extraction (past, current, or future) properly attributable to a taxpayer's taxable year. The number of barrels properly attributable to a year is easily measured by income. This interpretation follows closely what I perceive to be the intent of Congress without leading to inexplicable, illogical results as different factual cases emerge. Whatever interpretation the majority opinion is giving to "production," that interpretation is simply wrong.

[1] Unless otherwise provided, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

[2] I realize petitioners stipulated they had no "average daily production" of oil or gas; however, it is obvious they were equating "production" with extraction. Therefore, I would not base any denial of petitioners' percentage depletion deduction on that stipulation.

[3] I use the term "extraction" to mean the physical withdrawal of oil or gas.

First, the majority opinion could be read as defining "production" as extraction alone. Thus, the percentage depletion would be allowable only with respect to extraction occurring during the taxable year. While such a definition might come to mind upon a simplistic first reading of the statute, it becomes absurd after further reflection. Reading section 613A(c) as requiring extraction during the taxable year effectively ignores the mandate found in section 613A(c)(1) that allowable percentage depletion be computed "in accordance with section 613."

Section 613(a) grants a deduction calculated by taking a percentage of the gross income from property. Therefore, in order for section 613A(c) to mesh with section 613(a) both logically and administratively, "production" has to have some relation to gross income. See sec. 1.613-3(a), Income Tax Regs. The illogical result which obtains from interpreting section 613A(c) as requiring extraction in the taxable year is illustrated by the following example. Assume these facts: In December 1975, *B*, a cash basis, calendar year taxpayer, extracts 10,000 barrels of oil for which he is paid in 1976.[4] *B* neither extracts nor sells any more oil in 1975 or in 1976. If "production" meant *only* extraction, *B* would have "production" in 1975 but no gross income from the property in that year to serve as a oasis for calculating percentage depletion under section 613(a). In 1976, *B* would have gross income from the property, but it would not be with respect to any 1976 "production" since *B* did not extract any oil in 1976. In effect, *B* would be denied his percentage depletion allowance with respect to all 10,000 barrels. That is obviously not what Congress intended; therefore, I am very hesitant to attribute such reasoning to the majority.

Perhaps the majority opinion would allow our taxpayer, *B*, percentage depletion in 1976 since it is unclear whether it requires extraction in the same year as a percentage

[4] I shall be using examples throughout this dissent. For convenience, I am assuming a "depletable oil quantity" of 1,000 barrels. See sec. 1.613A(c)(3)(B). Thus a taxpayer could have 365,000 barrels of "production" in a calendar year of 365 days without having his "average daily production" exceed his "depletable oil quantity."

depletion deduction is claimed.[5] Respondent, in his proposed regulations under section 613A(c), takes the position that "production" occurs in the year income is received if and only if the income is backed by past or year-of-income extraction. See sec. 1.613A-3(a)(4) example (4), Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 13, 1977).[6] In my example above, *B* would have 10,000 barrels of "production" in 1976 because income from 10,000 barrels was recognized in 1976 under *B*'s method of accounting and because there had been at least 10,000 barrels extracted before or in the same year as the income. Thus, the proposed regulations reach a reasonable result when the income from oil or gas is received with or following extraction. But if income precedes extraction, that is, if advance payment is received, respondent contends there is no "production." That contention produces clearly untenable results.

Consider the following example: During 1975, *C*, a cash basis, calendar year taxpayer, extracts 2,000 barrels and receives income for 3,000 barrels. In 1976, *C* extracts 5,000 barrels and receives income for 4,000 barrels. Those facts are charted below:

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[5] The majority opinion, *supra* at 15, seems to imply an "exempt quantity of production." However, the matter is left unresolved.

[6] It is unclear under the proposed regulations whether, for purposes of determining if the depletable oil quantity has been exceeded, one would look to the income or to the required back-up extraction. Thus if 300,000 barrels were extracted each year for four years, and all 1,200,000 barrels were sold in year five, average daily production would exceed the depletable oil quantity in year five if reference were only made to income. See n.4, *supra*.

Arguably, income would be required to be backed up by extraction, but whether "production" is exempt would be determined by reference to the year of extraction and income would only determine the timing of the percentage depletion deduction. If 300,000 barrels were extracted each year for four years, all 1,200,000 barrels would be exempt "production" since the depletable oil quantity measured by extraction was never exceeded in any year. The entire year five income would be subject to a full allowance without reference to sec. 613A(c)(7)(A). Such an analysis would require a detailed and perhaps impossible tracing of extraction necessary to determine what extraction was being sold.

	1975	*1976*
Extraction in Barrels	2,000	5,000
Income in Barrels	3,000	4,000

Under the regulations approach (and, perhaps, the majority's), *C* would have 2,000 barrels of "production" in 1975 because, while 3,000 barrels gave rise to income, only 2,000 of those barrels were backed by extraction. In 1976, *C* would have 4,000 barrels of "production" because, while 5,000 barrels were extracted only 4,100 barrels gave rise to income. Even though *C* did not exceed his depletable oil quantity in either year, he is deprived of percentage depletion with respect to the 1,000 barrels which gave rise to income in 1975 but were extracted in 1976. Respondent gets the best of both worlds, and a harsh result obtains. Since respondent recognizes that "production" cannot mean just extraction *this* year but must necessarily somehow relate to gross income, I am at a loss to understand his rationale for distinguishing between income received before extraction and income received after or with extraction. In other words, if "production" is based on income when extraction has occurred in the past, it is capricious to say that "production" is not based on income solely because extraction will occur only in the future.[7]

Furthermore, not only does requiring income to be backed by extraction deny percentage depletion with respect to *any* oil paid for before it is extracted, respondent's interpretation creates additional accounting requirements. Extraction not matched by current sales must be noted and carried forward until the income therefrom is recognized for tax purposes. There is absolutely no statutory authority for such a requirement, which causes "production" to take on an excessively complicated and burdensome meaning. Therefore, I would reject respondent's income-backed-by-extraction interpretation of "production."[8]

[7] In essence, respondent in using sec. 613A(c) to revert to his position which the United States Supreme Court rejected in *Herring* v. *Commissioner*, 293 U.S. 322 (1934).

[8] Respondent's interpretation is found in proposed regulations which "carry no more weight than a position advanced on brief by the respondent." *F.W. Woolworth Co.* v. *Commissioner*, 54 T.C. 1233,

There is a third possible meaning which the majority might be attaching to "production," that is that "production" means a combination of extraction and income regardless of which occurs first. Under this approach, both elements are required with "production" for section 613A(c) purposes occurring when the later of extraction or income occurs.

Assume the following facts: In 1975, *D*, a calendar year, cash basis taxpayer extracts 1,000 barrels and receives income for 5,000 barrels. In 1976, *D* extracts 2,000 barrels and receives income for 1,000 barrels. In 1977, *D* extracts 5,000 barrels and receives income for 1,000 barrels. Those facts are charted below:

	1975	*1976*	*1977*
Extraction in Barrels	1,000	2,000	5,000
Income in Barrels	5,000	1,000	1,000

Under this third approach, which may or may not be that of the majority, *D* would have 1,000 barrels of "production" in 1975 since the required element of extraction had only occurred with respect to 1,000 barrels. In 1976, *D* would have 2,000 barrels of "production" because 2,000 more barrels had been both extracted and paid for by 1976. In 1977, *D* would have 4,000 barrels of "production" because, while 5,000 barrels were extracted, only 4,000 barrels worth of unaccounted for income would have been received. Thus, 1,000 barrels of extraction would be carried forward until it could be matched with its income.

While the above interpretation might achieve some interplay between sections 613A(c) and 613(a) without wholesale denial of percentage depletion with respect to advance payments, it would effectively rewrite section 613(a). As I have previously noted, section 613(a) grants a deduction based on a percentage of "gross income." Section 1.613-3(a), Income Tax Regs., defines "gross income" as "the amount for which the taxpayer sells the oil or gas." Thus, section 613(a) always has been applied as granting a

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1265-1266 (1970). The Court was not presented with final regulations which "must be sustained unless unreasonable and plainly inconsistent with the statute." See *Bingler* v. *Johnson*, 394 U.S. 741, 750 (1969).

deduction in the same year as the taxpayer recognizes the gross income under his method of accounting. See *Herring* v. *Commissioner*, 293 U.S. 322 (1934). See, e.g., *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969). See also sec. 1.611-2(a)(2), Income Tax Regs. There is no support for interpreting section 613(a) differently when section 613A(c) is involved than when section 613A(c) is not involved. Section 613A(c) does not rewrite section 613(a). In fact, section 613A(c)(1) directs computation "in accordance with section 613."

If, for section 613A(c) purposes, a percentage depletion deduction could be taken only when the later of extraction or income occurred, not only would long established interpretations of section 613(a) be overruled, but a serious mismatching of income and deductions would obtain. For example, if our taxpayer, *D*, had income from 1,200,000 barrels in year one prior to any extraction, he would have a large amount of income in that year but no percentage depletion deduction. If, in years two through five, *D* actually extracted 300,000 barrels each year he would be entitled to a deduction based on the prior income from those barrels even though he had no gross income in the years of extraction.[9] I cannot help but wonder whether such a result would represent a failure clearly to reflect income under section 446(b).[10] For the above reasons, I would reject any later-of-income-or-extraction interpretation of "production."

In summary, whatever interpretation the majority opinion is silently giving "production" in order to deny percentage depletion with respect to advance payments, I believe

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[9] Presumably, even though D received income with respect to all 1,200,000 barrels of his oil in one year he would get a percentage deduction with respect to all of it since he spread out extraction. See n.6, *supra*.

[10] Furthermore, if income were recognized in one year and percentage depletion deductions calculated on that income were taken in other years, the amount of deduction limits based on taxable income found in secs. 613(a) and 613A(d)(1) would be nonsensical. See also sec. 613A(c)(7)(C).

its position is unsupportable.[11] I see only one possible interpretation of "production."

In my view "production" means the extraction (past, current, or future) properly attributable to a taxpayer's taxable year as measured by the income received in that year. In other words, the number of barrels giving rise to income in a year is the number of barrels of "production" that year. Thus, if a taxpayer had the following extraction and barrels giving rise to income:

	1975	*1976*	*1977*
Extraction in Barrels	0	2,000	6,000
Income in Barrels	5,000	1,000	1,000

His "production" under sections 613A(c) would be 5,000 barrels in 1975, 1,000 barrels in 1976, and 1,000 barrels in 1977 since those are the number of barrels represented by income in each of those years.

Placing extraction in a year by reference to income interprets the term "production" without reading a myriad of calculations and carryovers into the statute. Not only is it a straightforward interpretation, it comports with the basic rule of natural resources taxation that depletion is

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[11] The majority opinion repeatedly notes that there has been no extraction under the oil and gas leases herein. The question which immediately leaps to mind is what if one barrel of oil had been extracted? Respondent's reply is clear—no percentage depletion deduction because that barrel of oil cannot be specifically traced to any of the advance royalties. See sec. 1.613A-7(f), Proposed Income Tax Regs., 42 Fed. Reg. 24287 (May 13, 1977); Rev. Rul. 81-44, 1981 I.R.B. 6. The majority opinion may well be adopting respondent's position; I cannot tell. On the other hand the majority opinion may contemplate allowing a percentage depletion deduction calculated on the part of the advance payment which they feel is attributable to the extraction. How it would achieve such attribution without ultimately allowing all income received to represent barrels is beyond me.

Moreover, if advance royalties are recoupable against earned royalties, respondent will allow percentage depletion with respect to the part of the advance payment which can be tied to recoupment to extraction in the year the advance payment is received. Nevertheless, that portion of the advance payment recouped through later years' extraction would not be subject to percentage depletion. See sec. 1.613A-3(a)(4), example (4), Proposed Income Tax Regs., 42 Fed. Reg. 24281 (May 13, 1977).

calculated on income rather than on the physical withdrawal of the mineral from its resting place. See sec. 1,611-2(a)(2), Income Tax Regs. See generally *Shamrock Oil & Gas Corporation*, 35 T.C. 979 (1961), affd. 346 F.2d 377 (5th Cir.), cert. denied 382 U.S. 892 (1965).

Furthermore, my interpretation fulfills what I perceive to be the intent of Congress. While section 613A(c)'s legislative history is limited, see majority, *supra* at n.20, the one salient fact that emerges from a perusal of the floor debates is that Congress intended to preserve the percentage depletion deduction for certain taxpayers, small independent producers and royalty owners, while severely curtailing its benefits to major oil producers.[12] Most importantly, there is no evidence of any intent to alter the manner in which percentage depletion is calculated or to overrule prior law concerning advance payments.[13]

Under pre-section 613A law, the treatment of advance royalties was clear. When the lessor-royalty owner took the advance payment into income, it was gross income from the property and subject to percentage depletion regardless of whether or not any oil and gas extraction had taken place. *Anderson* v. *Helvering*, 310 U.S. 404, 409 (1940); *Herring* v. *Commissioner*, 293 U.S. 322 (1934). As far as a lessor

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[12] If a taxpayer's average daily production exceeds his depletable oil quantity, he is still entitled to percentage depletion, but its benefits are greatly reduced. See sec. 613A(c)(7)(A).

[13] Conf. Rept. No. 94-120, 94th Cong., 1st Sess. (1975), 1975-1 C.B. 624, 629-630, states that:

> [T]he Senate amendment *retains* percentage depletion at 22 percent on a permanent basis for the small independent producer * * *. [Emphasis added.]

The above-quoted language indicates retention rather than abrogation of basic percentage depletion rules. However, the majority opinion disclaims that language by characterizing it as explaining an unenacted "Senate version of the bill." Majority, *supra* at 19. In fact, the legislative history reveals that the enacted Conference substitute "follows the Senate amendment in providing a small producer *exemption from the repeal of percentage depletion* for oil and gas." Conf. Rept. No. 94-120, *supra* at 630. [Emphasis added.] The enacted bill was, in effect, the Senate version—the only diffrences being phase downs of percentages and barrel amounts and elimination of a plowback requirement.

royalty owner is concerned, advance royalties are received with respect to extraction that will occur in the future rather than occurring now or in the past.[14] To restrict "production" in section 613A(c) to current or past extraction while excluding future extraction "in effect overrules prior case law without a clear statutory mandate." See Linden, *Oil and Gas Depletion Regulations: Complexity Compounded*, 24 Oil & Gas Tax Q. 351, 380 (1976). See also Bravenec, *Continued Availability of Percentage Depletion On Oil and Gas*, 23 Oil & Gas Tax Q. 204 (1975). On the other hand, interpreting "production" as extraction attributable to a year by reference to income allows almost fifty years of clear law to stand.

The majority opinion states that considering future extraction "would mean that 'production' as used in section 613A(c) should be read to mean 'sales of future production.'" Majority opinion, *supra* at 23. I strongly disagree. I am not maintaining that Congress accidentally wrote "production" rather than "sales." I do maintain that Congress intended "production during the taxable year" to include all extraction properly attributable to that year whether it be past, current, or future extraction. Even respondent recognizes that "production" must be interpreted with reference to income.

Furthermore, it is a simple matter to measure "production" in terms of income. "Production" is the number of barrels paid for whether or not the extraction of those barrels has actually occurred. Given the fluctuating prices of oil and gas, Congress drafted the section 613A(c) limitations or percentage depletion couched in terms of "production"

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[14] The treatment of the lessee-payor with respect to depletion and advance payments need not be consistent with the treatment of the lessor-payee. See discussion in *Shamrock Oil & Gas Corporation* v. *Commissioner*, 35 T.C. 979 (1961), affd. 346 F.2d 377 (5th Cir. 1965), cert. denied 382 U.S. 892 (1965). See also Price and Cassell, *Revenue Ruling 79-23 Ignores Tax Reduction Act of 1975*, 28 Oil & Gas Tax Q. 76 (1979). Nevertheless, it seems that the proposed regulations' denial of percentage depletion on advance payments is inconsistent with the "bonus exhaustion" rule of sec. 1.613-2(c)(5)(ii), Income Tax Regs., which is applicable to lessees. See Bravenec & Flagg, *Initial Proposed Section 613A Regulations*, 24 Oil & Gas Tax Q. 218, 224 (1975).

rather than some yearly income amount to avoid the need for constant amendments. However, by referring to section 613(a), Congress made it clear that "production" is inexorably tied to income. Respondent recognizes the tie between income and "production" when the receipt of income is accompanied by current or past extraction, but refuses to acknowledge that tie when income is received prior to extraction.[15] I simply do not see how he can justify such a distinction.

Based on the foregoing, I would hold that petitioners are entitled to a percentage depletion deduction calculated on the full $7,600 in advance royalties received by them in 1975. Those advance royalties were paid with respect to oil and gas extraction, albeit future extraction. See *Anderson* v. *Helvering*, *supra*. Since the taxable year involved herein is 1975, petitioners' "depletable oil quantity" was 2,000 barrels. See sec. 613A(c)(3). Thus, petitioners were allowed 720,000 barrels of "production" in 1975 before their "average daily production" would exceed their "depletable oil quantity."[16] By no stretch of the imagination would $7,600

[15] The majority attempts to disclaim any income based interpretation of "production" as creating "numerous practical problems," majority, *supra* at 24, due to differences between depletable oil quantities and depletable natural gas quantities. A careful reading of sec. 613A(c) belies such worries. Section 613A(c)(3) sets a depletable oil quantity (e.g. 2,000 barrels) while sec. 613A(c)(4) in effect converts gas to barrels (6,000 cubic feet per barrel) which uses up part of the depletable oil quantity. Secondary or tertiary production also reduces the depletable oil quantity. In reality, an *overall* limit of barrels (e.g. 2,000) is being imposed regardless of whether the barrels are oil or gas. The statute merely ensures that a taxpayer does not get a full barrel allowance of *each*.

The only arguable problem is that secondary or tertiary barrels are depleted at 22 percent until 1983 while other barrels fall to 18 percent by 1983. See secs. 613A(c)(6)(A)(ii) and 613A(c)(5). I do not envisage the problem being insurmountable by the burden of proof. At the time of payment, it will probably be known whether secondary or tertiary "production" is involved. The same is true concerning gas "produced from geopressured brine." Sec. 613A(b)(3)(C). Additionally, I note that current sec. 613A(b)(2) was nonexistent in 1975 and should not be considered in a case concerning petitioners' 1975 taxable year.

[16] As shown on their Federal income tax return for 1975, petitioners were calendar year taxpayers in 1975. Calendar year 1975 was made

represent anything near 720,000 barrels in 1975. Accordingly, I would allow petitioners their claimed percentage depletion deduction.[17]

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up of 365 days. Thus, if 720,000 barrels were petitioners' "aggregate production" in 1975, their "average daily production" would be 2,000 barrels/day. See sec. 613A(c)(2)(A).

[17] Of course, if there is never any extraction under the leases involved in this case, petitioners would be required to recapture the percentage depletion deduction. See sec. 1.612-3(b)(2), Income Tax Regs. See also majority, *supra* at n.24.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
CHICAGO, ILLINOIS 60604

No. 81-2463

May 7, 1982

FRED L. AND MARY A. ENGLE, PETITIONERS-APPELLANTS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE.

APPEAL FROM THE UNITED STATES TAX COURT.

Opinion by Judge Pell

JUDGMENT—ORAL ARGUMENT

Before
Hon. WILBUR F. PELL, JR., *Circuit Judge*
Hon. THOMAS E. FAIRCHILD, *Senior Circuit Judge*
Hon. WILLIAM J. BAUER, *Circuit Judge*

This cause was heard on the record from the United States Tax Court and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said Tax Court in this cause appealed from be, and the same is hereby, REVERSED, with costs, in accordance with the opinion of this Court filed this date.

APPENDIX D

IN THE UNITED STATES COURT OF CLAIMS

Nos. 15-80T and 16-80T

(Decided September 22, 1982)

PHILIP D. FARMAR AND MARIAN J. FARMAR, AND A. A. AND MARY S. SUGG

v.

THE UNITED STATES

William M. Linden, for plaintiffs. *James A. Carter*, attorney of record. *Marvin K. Collie* and *Vinson & Elkins*, of counsel.

Maxine C. Champion, with whom as *Assistant Attorney General John F. Murray*, for defendant. *Theodore D. Peyser* and *Donald H. Olson*, of counsel.

Before COWEN, *Senior Judge*, DAVIS and NICHOLS, *Judges*.

ON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT AND PLAINTIFFS' CROSS-MOTION FOR SUMMARY JUDGMENT

DAVIS, *Judge*, delivered the opinion of the court:

Plaintiffs, Philip D. and Marion J. Farmar, and A.A. and Mary S. Sugg, bring these consolidated refund suits to recover deficiencies assessed by the Internal Revenue Service (IRS or Service) for the taxable year 1976. Farmar and Sugg are owners of a mineral estate in lands located in Texas. They leased their ownership interests to two companies interested in oil and gas exploration. As compensation for the agreements they received lease bonuses, payable in several yearly installments; they were also to receive

royalties as oil and gas was extracted from the land. The bonuses were payable no matter if oil or gas was ever produced.[1]

In 1976, oil and gas was extracted and royalties were paid to the plaintiffs. They also received bonus payments that year. On their 1976 tax returns, they claimed a 22 percent percentage depletion deduction on both the royalty income and the bonus payments.

The IRS assessed deficiencies in federal income taxes for 1976 based on its disallowance of the percentage depletion deduction on the bonus income.[2] Taxpayers paid these deficiencies and filed claims for refunds. These were denied, leading to the present actions. Both parties have moved for summary judgment, and we agree that the basic facts are not in dispute. On those facts, we hold for the defendant.

I

For the year before us (1976), the relevant statutory tax provision is § 613A of the Internal Revenue Code, 26 U.S.C. § 613A (1976), which abolishes the percentage depletion allowance for oil and gas wells, restricting oil and gas developers to cost depletion.[3] A limited exception is provided under § 613A(c) for small independent producers and royalty owners. (It is common ground that plaintiffs fall within the category.) Subsection (c) provides that:

> (c) Exemption for independent producers and royalty owners.—
>
> (1) *In general.*—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

---

[1] If the operators abandoned the leases, they could not recover any part of the bonuses.

[2] There is no controversy over plaintiffs' right to percentage depletion deductions with respect to the royalties. Nor is there any dispute before us over cost depletion.

[3] Section 613A was enacted as part of the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501, 89 Stat. 26 (1975).

(A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the table contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

26 U.S.C. § 613A(c)(1) (1976).[4] Taxpayers covered by this subsection make their determination of gross income based on the pre-1975 rules of § 613, 26 U.S.C. § 613 (1976), and then apply the limitations and restrictions of § 613A for depletion on that income.

Plaintiffs' position is that § 613A retained the pre-existing system of depletion for independent producers and royalty owners, and merely established maximum limits on the

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[4] The next five segments of subsection (c) state:

(2) *Average daily production.*—For purposes of paragraph (1)—

(A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.

In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary).

(3) *Depletable oil quantity.*—

(A) *In general.*—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) *Phase-out table.*—For purposes of subparagraph (A)—

amount of oil and gas subject to percentage depletion. They argue that the scheme for determining the amount and timing of depletion allowances on bonus payments, developed in the Supreme Court decisions of *Burnet* v. *Harmel*, 287 U.S. 103 (1932); *Herring* v. *Commissioner*, 293 U.S. 322 (1934); and, *Douglas* v. *Commissioner*, 322 U.S. 275 (1944), is unchanged by the 1975 law. In their view, the bonus income is still subject to percentage depletion in the year it is received as long as there is oil or gas produced at some point during the life of the lease. (That was undoubtedly the pre-1975 law.) They say that bonus income can be converted to barrels per day (or cubic feet of gas) in the

In the case of production during the calendar year:	The tentative quantity in barrels is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(4) *Daily depletable natural gas quantity.*—For purposes of paragraph (1), the depletable natural gas quantity of any taxpayer for any taxable year shall be equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the taxpayer elects to have this paragraph apply. The taxpayer's depletable oil quantity for any taxable year shall be reduced by the number of barrels with respect to which an election under this paragraph applies. Such election shall be made at such time and in such manner as the Secretary shall by regulations prescribe.

(5) *Applicable percentage.*—For purposes of paragraph (1)—

In the case of production during the calendar year:	The applicable percentage is:
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

year of actual production,[5] and at that time confined to the quantity limitations prescribed in § 613A. According to the taxpayers, this conversion reconciles § 613A and § 613 so that § 613A establishes only a quantity limitation and not a production precondition to application of the percentage depletion allowance.

The government, on the other hand, insists that under the new statute, (a) depletion must be tied to actual production in the taxable year (here, 1976); (b) lease bonuses (such as those in the current cases) are not depletable at all because they are not connected with actual production; and (c) the pre-1975 law, as interpreted by the Supreme Court, was changed to allow depletion (to independent owners and royalty owners) only with respect to payments dependent on actual production in the taxable year.

II

This difference is not an easy one to resolve, and neither the text of the statute nor its legislative history gives a resounding answer. There is already a judicial dispute over the correct approach. The full Tax Court, with one dissent, has come down on the government's side. *Glass* v. *Commissioner*, 76 T.C. 949 (1981) (lease bonuses), and *Engle* v. *Commissioner*, 76 T.C. 915 (1981) (advance royalties). Since we heard oral argument in the present cases, the Seventh Circuit has reversed the Tax Court's *Engle* ruling. *Engle* v. *Commissioner*, No. 81-2463 (7th Cir. May 7, 1982). That court held that a percentage depletion allowance is permissible with respect to advance royalties, whether or not actual production occurs in the year the

[5] This conversion is accomplished, under taxpayers' theory, by allocating the bonus payment(s) over the expected productive life of the well and then dividing the price per barrel received on the extracted oil in a particular year into the bonus payment allocated to that year. This gives a barrel per day figure which is added to actual production quantities to determine if the depletable oil or gas quantities established by the statute, 26 U.S.C. § 613A(c)(3), (4) (1976), have been exceeded. Complications arise when production and sale do not occur in the same year but those problems are not present in the cases now before us.

deduction is taken. The court's theory strongly suggests, though the opinion does not hold, that the same rule applies to lease bonuses like those we have here.

In evaluating this troublesome problem for ourselves, we bear in mind some general canons for interpreting federal tax legislation. The traditional postulate is that ambiguities in statutory language should be resolved against the government. *McFeely* v. *Commissioner*, 296 U.S. 103, 111 (1935); *Gould* v. *Gould*, 245 U.S. 151, 153 (1917). However, a recognized exception, applicable to the present problem, is that provisions for deductions from income are to be strictly construed and applied in particular cases only if clearly provided for by the statutory language. *Equitable Life Assurance Society* v. *Commissioner*, 321 U.S. 560, 564-65 (1944); *White* v. *United States*, 305 U.S. 281, 292 (1938); *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U.S. 686, 689-90 (1935); *Parker Pen Co.* v. *O'Day*, 234 F.2d 607, 609 (7th Cir. 1956); *cf. A. Crauford Greene* v. *United States*, 145 Ct. Cl. 259, 268, 171 F. Supp. 459, 464, *cert. denied*, 360 U.S. 933 (1959). Deductions are a matter of legislative grace and a taxpayer has the burden of proving his entitlement to the income reduction. *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943); *Deputy* v. *DuPont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934); *cf. United States* v. *Stewart*, 311 U.S. 60, 71 (1940). More specifically for these cases, a taxpayer attempting to deduct a depletion allowance must establish that it is clearly allowed by legislation. *Parsons* v. *Smith*, 359 U.S. 215, 219 (1959); *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956); *Reinecke* v. *Spalding*, 280 U.S. 227, 232-33 (1930); *South Jersey Sand Co.* v. *Commissioner*, 267 F.2d 591, 593 (3d Cir. 1959); *Jefferson & Clearfield Coal & Iron Co.* v. *United States*, 83 Ct. Cl. 491, 494, 14 F. Supp. 918, 920, *cert. denied*, 299 U.S. 581 (1936). Ambiguities should be resolved against the taxpayer. *Consolidated Chollar Gould & Savage Min. Co.* v. *Commissioner*, 133 F.2d 440, 441 (9th Cir. 1943).

III

Though their meaning is not absolutely plain, the words of § 613A(c) suggest to us that Congress restricted percentage depletion to income derived from actual production during the taxable year, and did not merely establish a top limitation on the quantities of oil and gas subject to that kind of depletion.

It is clear, in the first place, that § 613A controls the allowance for percentage depletion (which is now limited to independent producers and royalty owners). Subsection (a) of § 613A provides (as its "general rule") that "Except as otherwise provided *in this section* [*i.e.*, § 613A], the allowance for depletion under section 611 *with respect to any oil or gas well* shall be computed *without* regard to section 613." [emphasis added] The question, then, is the method of calculation mandated by § 613A—not the method used when § 613 stood alone.

In turn, subsection (c) of § 613A (see Part I and footnote 4, *supra*), requires that the percentage oil and gas depletion allowance be computed "with respect to" "the taxpayer's average daily production" of domestic crude oil or natural gas. 26 U.S.C. § 613A(c)(1) (1976). The allowable depletable quantities are then defined in terms of production levels and the applicable depletion percentage rate and allowance is based on production during the particular taxable year. 26 U.S.C. § 613A(c)(2), (3), (4), (5) (1976).[6] The sheer fact is that, throughout § 613A(c) and (d), Congress repeatedly refers to "production" of oil and gas, and

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[6] Subsection (c)(2) deals with "the taxpayer's average daily production of domestic crude oil or natural gas *for any taxable year* * * *." [emphasis added] Production "for the [or any] taxable year" is likewise mentioned in subsection (c)(3)(ii) and subsection (c)(4). Subsection (c)(5) deals with "production during [specified] calendar year[s]." Other of the remaining provisions of subsection (c) also refer to "production" or "average daily * * * production" "for any taxable year" (subsections (c)(6), (c)(7), (c)(9), (c)(10), and (c)(12)). Subsection (d) (limiting the amount of the depletion allowance) likewise refers to "production."

frequently refers to said "production" for or during the "taxable year," in a way appearing to suggest that actual extraction was in mind.

This statutory language regularly linking depletion directly to production during a taxable year indicates to us that Congress wanted depletion to be allowable only "with respect to" income derived from, or connected with, actual extraction during the taxable year. "Production" normally means physical extraction—in the oil and gas industry as well as in common usage. Conversely, the text of § 613A is not framed so as to suggest that the depletable quantities are merely maximum limitations on the allowance of a depletion deduction, unrelated (or minimally related) to actual production.[7] The actual language embodies no such connotation.

Both the present taxpayers and the Seventh Circuit in *Engle, supra*, have stressed that this reading represents a sharp departure from the prior law, under which depletion was allowed on lease bonuses, provided that some amount of production occurred under the lease. *See Burnet* v. *Harmel*, *Herring* v. *Commissioner*, and *Douglas* v. *Commissioner*, all *supra*. That is true, but not controlling. If the words of later legislation fit better with such a departure than they do with retention of prior law, new language should be accepted as written (if, as we show in Part IV, *infra*, is the case here, the legislative history does not indicate otherwise). "If the section as amended is inconsistent with prior judicial interpretation of related sections, it is presumed that the legislature knew thereof, and the amendment controls." *C. Sands, Sutherland Statutory Construction*, § 22.5 at 197 (4th ed. 1972).

In the light of the specific wording of § 613A with its stress on what seems to be actual production during the taxable year, it is hard for us to believe that in these cases—involving lease bonuses which were expressly payable regardless of whether oil or gas was ever produced

[7] The statute does not provide, for example, for plaintiffs' method of converting bonus income into barrels of oil; rather, the limitation on depletable quantities is phrased in terms of barrels of oil production (or cubic feet of natural gas), and not as an income limit.

while the lease was in effect—Congress wished percentage depletion to be fully allowed each year on those bonuses (up to the stated limits) so long as a minimal amount of oil was extracted at sometime during the lease period. That may have been the case under the previous statute (*see Douglas* v. *Commissioner*, *supra*, 322 U.S. at 285 (1944)), but on its face § 613A strikes us as quite inconsistent with that rule.

Plaintiffs contend, nevertheless, that lease bonuses are sufficiently tied to production because of their economic relationship to royalties. Payment for an oil and gas lease is usually composed of a bonus and royalties. We are told that the value of the lease is determined by the expectation of a certain amount of production and that this expectation determines the price of the lease. The price is then divided (it is said) between a bonus portion and a royalty portion. The two parts of the total payment are said to be interconnected so that as one increases the other is decreased while the price remains the same, always based on the buyer's expectation of production levels.

The fundamental flaw in this analysis (assuming that plaintiffs are correct about the process of assessing the value of a lease and the division of the payment) is that the lease bonus is not tied to *actual production* but only to the parties' expectations of production. But the statutory language in § 613A infers a connection with actual, not expected, production. The lease bonus, while it may affect the predetermined royalty payment rates, is not adjusted with or sufficiently connected to actual production levels. On the contrary, it is payable here no matter what the actual production turns out to be, and even if there is no actual production. Moreover, the bonuses in these cases were per acre payments (*i.e.*, based on a land unit), not calculated per barrel produced (actual or anticipated).

Nor do we consider it a telling defect in the government's (and our) understanding of § 613A that Congress retained the old § 613 (which, standing alone, allowed percentage depletion of lease bonuses—see *supra*) in the computation of such depletion for independent operators and royalty owners. We agree with defendant that § 613A simply added a further screen for the percentage depletion

deductions of those taxpayers. They first have to show, under § 613, that they seek depletion with respect to gross income from oil property and that the allowance does not exceed the statutory percentage of their taxable income from the property. Then, the taxpayers must pass through the additional, finer screen of § 613A—showing that the depletion is based on actual production not exceeding the barrel limits imposed by the new statute. Both provisions (§ 613 and § 613A) play their separate roles, but in conjunction with each other. There is no contradiction.

This may very well have been an inartistic or awkward way in which to frame the new legislation, but courts have no right to demand legislative perfection, or even high marks in drafting—if we can ascertain the congressional purpose.[8] For us to read subsection (c) merely as imposing a top limitation, without regard to the amount of actual production, is to degrade the specific words Congress consistently used when it added § 613A to the law.

IV

A. The legislative history of § 613A is at best of minor help, but at the least we are convinced that it does not contain anything contravening the reading we (as well as the Tax Court and the government) have given to the statute.

In 1975, both Houses of Congress began consideration of a bill to reduce taxes. H. R. 2166, 94th Cong., 1st Sess. (1975). As reported, the bills did not touch on oil and gas depletion. On the floor of each House, after the bill was reported out by the respective committees, there were introduced amendments affecting the percentage depletion allowance as applied to oil and gas wells. The House version repealed the deduction altogether.[9] 121 Cong. Rec. 4638, 4651 (1975). The Senate version likewise provided for

[8] We note that this provision was basically inserted on the floor, without much time or opportunity for careful formulation in committee, or rebuilding from the ground up.

[9] A version of the amendment that retained percentage depletion for income from small quantities of oil and gas (3,000 barrels of oil or 8,000,000 cubic feet of natural gas) was narrowly defeated on the House floor on the same day. 121 Cong. Rec. 4639- 41,4645 (1975)[*sic*].

immediate repeal of percentage depletion but included an exemption for limited quantities (2,000 barrels per day and a natural gas equivalent) of oil and gas. 121 Cong. Rec. 7770-73, 7807, 7813 (1975). The conference committee adopted the Senate approach, adding an eventual complete phase-out of the allowance. H. Conf. Rep. No. 120, 94th Cong., 1st Sess. 68 *reprinted in* [1975] U.S. Code Cong. & Ad. News 132-34. This language was enacted as § 613A.

There was no floor discussion (nor statement in the conference report) directly on the problem before us, one way or the other. We stress, however, that nothing said in the debate or report was inconsistent with the requirement that depletion cannot be had on lease bonus payments. Certainly, reading § 613A(c) as confining percentage depletion to income received from actual production does not conflict with what appears to have been one of the purposes of the oil-and-gas depletion portions of the 1975 tax act—the encouragement of actual and immediate production of those commodities. *See* Comment, *Tax Law and the Energy Crisis*, 64 Cal. Law Rev. 1040, 1061-63 (1976).

B. The only reference to the precise issue before us occurred in the immediately preceding Congress. In 1974, a bill was introduced in the House to eliminate the depletion allowance on income earned from oil and gas wells. H.R. 17488, 93d Cong., 2d Sess. (1974). It included an exemption for small interest holders and allowed the deduction "with respect to so much of his average daily production of domestic crude oil as does not exceed 3,000 barrels."[10]

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[10] H.R. 17488, § 112(a):

(b) *3,000 Barrel-A-Day Exemption.*—

(1) *In general.*—If the taxpayer elects the application of this subsection for the taxable year, then with respect to so much of his average daily production of domestic crude oil as does not exceed 3,000 barrels, the percentage referred to in section 613(a) shall be 15 percent in the case of gross income from the property before January 1, 1979.

(2) *Average daily production.*—For purposes of paragraph (1), the taxpayer's average daily production of domestic crude oil shall be determined by dividing his aggregate production of domestic crude oil during the taxable year by the number of days in such taxable year.

Concerning this tie to actual production, the House Committee on Ways and Means (reporting the bill) explained:

> The small production exemption applies to gross income attributable to a proportion of *actual* production ... Thus, the 15 percent rate applies only to gross income attributable to oil which is sold or removed from the premises and not to other types of depletable income. *For example, a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions.* [emphasis added]

H. Rep. No. 1502, 93d Cong., 2d Sess. 46 (1974). The bill was introduced late in the congressional session and was never acted upon by the full House or introduced in the Senate.

In *Engle*, the Seventh Circuit gave no credit whatever to this committee statement because it related to an earlier bill in an earlier Congress, and there is no indication that the later Congress (particularly the Senate) knew of or considered those views. We do not lean heavily on the earlier report, but we do not disregard it entirely (as the Seventh Circuit did). The prior bill was very similar to § 613A (though different in limits and percentages). There are, too, references in both the House and Senate debates in 1975 to the small producer exemption in the 1974 bill.[11] 121 Cong. Rec. 4646, 6903, 7777 (1975). These observations are entitled to some consideration (as indicating some knowledge of the earlier bill) because this section of the statute was initially adopted as a floor amendment (after completion of the House and Senate committee reports) and there was extensive debate on the oil depletion allowance part of that bill. *See* 121 Cong. Rec. 4622-52, 6903-05, 7218-29, 7238-48, 7263-7308, 7772-7813, 8128-29, 8860, (1975); *Depletion Allowance, Hearing Before the Subcomm. on Energy of the Senate Comm. on Finance*, 94th Cong., 1st Sess. (1975).

[11] These comments do not refer to the production-link requirement but they do indicate an awareness, by at least some of the members involved in the floor discussion, of the 1974 bill and the exemption for small producers it contained.

Because the House bill in the 1975 Congress originally included total repeal of the oil depletion allowance, plaintiffs contend that the House could not have intended to follow the 1974 House Committee on Ways and Means bill; and therefore the prior statement should be wholly bypassed. But the 1975 House version entirely repealing the allowance was not ultimately adopted and it cannot represent the intent of the House with respect to § 613A. The conference committee substitute, which contained exemption language very similar to that in the prior H.R. 17488, was eventually adopted by both Houses and is a better indication of congressional p pose. *See Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 246 n.4, 264 n.31, 32, and accompanying text (1945). Moreover, even during the initial House discussions, an exemption for independent producers and royalty owners, based on production levels, was considered and narrowly voted down. *See* footnote 9, *supra*. The idea of a special exemption for small entities, expressly involving production, was very much in the air in the 94th Congress, and it is not unlikely that the prior report was known to several, if not many, of the members who considered § 613A.

On the whole we cannot completely disregard the 1974 committee report as having no bearing on the 94th Congress' consideration and passing of § 613A. It is the only significant reference to the issue before us, and clearly supports the government's position. In the absence of any real contradictory history, that report should have some (though, of course, not compelling) weight.

C. We do not consider this item of history overborne by the failure of Congress to address directly the Supreme Court decisions which would be superseded by our reading of § 613A. The 1974 Committee report did not do so and it is expecting too much to look for such discussion in a later floor debate devoted entirely to other aspects of oil depletion. The important point is whether the terms of the new statute are inconsistent with those earlier decisions. If they appear to be so—and we think that they do—there is no requirement that Congress say so explicitly. *See* Part III, *supra*.

V

The Service has consistently interpreted § 613A contrary to plaintiffs' view, and while it is not at all binding we should not overturn that position unless we find if contrary to the statute—as we have not done. In its revenue rulings, the IRS has held that income attributable to a lease bonus is not subject to the percentage depletion allowance. Rev. Rul. 81-44; Rev. Rul. 81-266.[12]

Plaintiffs say that Rev. Rul. 81-266, *supra*, establishes that a lease bonus is subject to a percentage depletion allowance—that, by holding that the lessee must subtract the bonus from its gross income calculation thereby excluding the lessee from taking the deduction, the Service must be endorsing depletion of that income by the lessor. Under the bonus exhaustion rule, taxpayers argue, the deduction may be taken by either the lessor or the lessee, but not both, and removing it from the lessee simply shifts the depletion allowance to the lessor (or vice versa). This is,

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[12] Revenue rulings are not binding on this court. *Pacific Far East Line, Inc.* v. *United States*, 211 Ct. Cl. 71, 93, 544 F.2d 478, 490 (1976); *State Bank of Albany* v. *United States*, 209 Ct. Cl. 13, 19, 530 F.2d 1379, 1382 (1976); *Stubbs, Overbeck & Associates, Inc.* v. *United States*, 445 F.2d 1142, 1146-47 (5th Cir. 1971) (J. Skelton). They are not accorded a presumption of correctness but must be analyzed for consistency with the statute. *Estate of Sanford* v. *Connecticut*, 308 U.S. 39, 52-54 (1939); *United States* v. *Missouri Pacific Railroad Co.*, 278 U.S. 269, 280 (1929); *United States* v. *Eddy Bros.*, 291 F.2d 529, 531 (8th Cir. 1961); *Investment Annuity, Inc.* v. *Blumenthal*, 442 F. Supp. 681, 687-94 (D.C. Cir. 1977), *rev'd on other grounds*, 609 F.2d 1 (D.C. Cir. 1979), *cert. denied*, 446 U.S. 981 (1980). Nevertheless, they are entitled to some consideration and carry some weight, especially when the statutory language is considered ambiguous. *Gino* v. *Commissioner*, 538 F.2d 833, 835 (9th Cir.), *cert. denied*, 429 U.S. 979 (1976); *Eddy Bros.*, 291 F.2d at 531; *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201, 228-29 (N.D. Iowa 1949). This stance is consistent with the general deference accorded an IRS interpretation, as well as the Commissioner's authority to choose between reasonable interpretations. *National Muffler Dealers Assn.* v. *United States*, 440 U.S. 472, 477, 488 (1979); *United States* v. *Correll*, 389 U.S. 299, 307 (1967); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336, 340 (2d Cir. 1980).

however, an incorrect reading of the revenue ruling. Rev. Rul. 81-266 expressly upholds the conclusion in Rev. Rul. 81-44 excluding bonus income from percentage depletion. It also points out that under § 613A the lessee cannot deplete bonus income but must subtract it from its gross income under § 613. Neither lessor nor lessee can obtain percentage depletion.

In addition to the revenue rulings, the administrative position is bolstered by the regulation proposed by the Service to implement § 613A(c) which emphatically excludes percentage depletion on lease bonus payments.[13] Proposed regulations are not binding but have some authority as an indication of administrative practice. *See Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201, 229 (N.D. Iowa 1949).

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[13] Proposed Treasury Regulation 1.613A:

§ 1.613A-3 *Exemption for independent producers and royalty owners.*

* * * * *

(4) The provisions of this paragraph may be illustrated by the following examples:

* * * * *

Example (5). In 1975, E leased an oil property to F, receiving a lease bonus. With respect to the lease bonus, E is entitled to take cost depletion but not percentage depletion.

* * * * *

§ 1.613A-7 *Definitions.*

* * * * *

(f) *Average daily production.* (1) The term "average daily production" means the taxpayer's average production of domestic crude oil or natural gas, as the case may be, which is produced after December 31, 1974, and to which gross income from the property is attributable during the taxable year divided by the number of days in such year. * * * Notwithstanding the provisions of § 1.612-3, of this chapter, in computing the average daily production for a taxable year only oil or gas which has been produced by the close of such taxable year shall be taken into account. For example, advanced royalties (to the extent that actual production during the taxable year is insufficient to earn such royalties) and lease bonuses, while taken into account for purposes of sections 61 and 612 (relating to the definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A(c). * * *

VI

Primarily on the basis of the language of § 613A, but with minor help from the legislative history and the consistent administrative interpretation, we conclude that plaintiffs have not met the burden of showing that they are entitled to a deduction under § 613A—they have not convinced us that the statute omits the requirement of a direct link to actual production for oil and gas income to be subject to the percentage depletion allowance. Our overall views do vary from those expressed by the *Engle* case, but the ultimate holdings of the two sets of cases may not necessarily be inconsistent. We are concerned here with lease bonuses, not tied at all to actual production, and we confine our decision to that subject. The Seventh Circuit dealt with advance royalties which may possibly be considered somewhat different, and more closely related to actual production.[14]

For these reasons, we grant defendant's motion for summary judgment and deny plaintiffs' motion. The petitions are dismissed.

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[14] *Engle* focused on the question whether the depletion deduction and actual production must be in the same year.

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * * *

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to

the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) [As amended by Section 501(b)(2)(A), Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 53.] *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 22 Percent—

(A) sulphur and uranium; and

(B) if from deposits in the United States—anorthosite, clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanitum, tungsten, vanadium, and zinc.

* * * * *

(d) [As amended by Section 501(b)(1), Tax Reduction Act of 1975, *supra* 89 Stat. 53.] *Denial of Percentage Depletion in Case of Oil and Gas Wells.*—Except as provided in section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section.

* * * * *

SEC. 613A. [As amended by Section 501(a), Tax Reduction Act of 1975, *supra*, 89 Stat. 74 *et seq.*] LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS.

(a) *General Rule.*—Except as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613.

(b) *Exemption for Certain Domestic Gas Wells.*—

(1) *In general.*—The allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) regulated natural gas,

(B) natural gas sold under a fixed contract and

(C) any geothermal deposit in the United States or in a possession of the United States which is determined to be a gas well,

and 22 percent shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) *Definitions.*—For purposes of this subsection—

(A) *Natural gas sold under a fixed contract.*—The term "natural gas sold under a fixed contract" means domestic natural gas sold by the producer under a contract, in effect on February 1, 1975, and at all times thereafter before such sale, under which the price for such gas cannot be adjusted to reflect to any extent the increase in liabilities of the seller for tax under this chapter by reason of the repeal of percentage depletion for gas. Price increases after February 1, 1975, shall be presumed to take increases in tax liabilities into account unless the taxpayer demonstrates to the contrary by clear and convincing evidence.

(b) *Regulated natural gas.*—The term "regulated natural gas" means domestic natural gas produced and sold by the producer, before July 1, 1976, subject to the jurisdiction of the Federal Power Commission, the price for which has not been adjusted to reflect to any extent the increase in liability of the seller for tax under this chapter by reason of the repeal of percentage depletion for gas. Price increases after February 1, 1975, shall be presumed to take increases in tax liabilities into account unless the taxpayer demonstrates the contrary by clear and convincing evidence.

(c) *Exemption for Independent Producers and Royalty Owners.*—

(1) *In general.*—Except as provided in subsection (d), the allowance for depletion under section 611 shall be computed in accordance with section 613 with respect to—

(A) so much of the taxpayer's average daily production of domestic crude oil as does not exceed the taxpayer's depletable oil quantity; and

(B) so much of the taxpayer's average daily production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity;

and the applicable percentage (determined in accordance with the taxable contained in paragraph (5)) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) *Average daily production.*—For purposes of paragraph (1)—

(A) the taxpayer's average daily production of domestic crude oil or natural gas for any taxable year, shall be determined by dividing his aggregate production of domestic crude oil or natural gas, as the case may be, during the taxable year by the number of days in such taxable year, and

(B) in the case of a taxpayer holding a partial interest in the production from any property (including an interest held in a partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production of such property by the taxpayer's percentage participation in the revenues from such property.

In applying this paragraph, there shall not be taken into account any production of crude oil or natural gas resulting from secondary or tertiary processes (as defined in regulations prescribed by the Secretary).

(3) *Depletable oil quantity.*—

(A) In general.—For purposes of paragraph (1), the taxpayer's depletable oil quantity shall be equal to—

(i) the tentative quantity determined under the table contained in subparagraph (B), reduced (but not below zero) by

(ii) the taxpayer's average daily secondary or tertiary production for the taxable year.

(B) *Phase-out table.*—For purposes of subparagraph (A)—

In the case of production during the calendar year:	The tentative quantity in barrels is:
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

* * * * *

Proposed Treasury Regulations on Income Tax (1954 Code), 42 Fed. Reg. 24279 *et seq.* (1977) (to be codified at 10 C.F.R. Part 1) (May 13, 1977):

§ 1.613A-3 Exemption for Independent Producers and Royalty Owners [42 Fed. Reg. 24281-24282 (1977)].

(a) *General rule.* (1) Except as provided in section 613A(d) and § 1.613A-4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after that date, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily production (as defined in paragraph (f) of § 1.613A-7) of domestic crude oil (as defined in paragraphs (a) and (g) of § 1.613A-7) as does not exceed the taxpayer's depletable oil quantity (as defined in paragraph (h) of § 1.613A-7), and

(ii) So much of the taxpayer's average daily production of domestic natural gas (as defined in paragraphs (a) and (b) of § 1.613A-7) as does not exceed the taxpayer's depletable natural gas quantity (as defined in paragraph (i) and § 1.613A-7),

and the applicable percentage (determined in accordance with the table in paragraph (c) of this section) shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(2) Except as provided in section 613A(d) and § 1.613A-4, the allowance for depletion under section 611 with respect to oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such date and before January 1, 1984, shall be computed in accordance with section 613 with respect to:

(i) So much of the taxpayer's average daily secondary of tertiary production (as defined in paragraph (k) of § 1.613A-7) of domestic crude oil as does not exceed the taxpayer's depletable oil quantity (determined without regard to section 613A(c)(3)(A)(ii), and

(ii) So much of the taxpayer's average daily secondary or tertiary production of domestic natural gas as does not exceed the taxpayer's depletable natural gas quantity (determined without regard to section 613A(c)(3)(A)(ii),

and 22 percent shall be deemed to be specified in subsection (b) of section 613 for purposes of subsection (a) of that section.

(3) For purposes of this section there shall not be taken into account any production with respect to which percentage depletion is allowed pursuant to section 613A(b) or is not allowable by reason of section 613A(c)(9).

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, a calendar year taxpayer, owns an oil producing property with 100,000 barrels of production to which income was attributable for 1975 and a gas producing property with 1,200,000,000 cubic feet of production to which income was attributable for 1975. Under section 613A(c)(4), the oil equivalent of 1,200,000,000 cubic feet of gas is 200,000 barrels, bring A's total production of oil and gas to which income was attributable for 1975 to the equivalent of 300,000 barrels of oil. A's average daily production was 821.92 barrels (300,000 barrels ÷ by 365 days) which is less than the depletable oil quantity (2,000 barrels) before reduction for any election by A under section 613A(c)(4). Accordingly, A may make such an election with respect to his entire gas production and thereby be entitled to percentage depletion with respect to his entire 1975 income from production of oil and gas. A's allowable depletion pursuant to section 613A(c) for his oil and gas properties would be the amount determined under section 613(a) computed at the 22 percent rate specified in section 613A(c)(5) for 1975.

Example (2). B, a calendar year taxpayer, owns oil producing properties with 365,000 barrels of production to which income was attributable for 1975. B was a retailer of oil and gas for only the last 3 months of 1975. B's average daily production for 1975 was 1,000 barrels (365,000 barrels ÷ by 365 days).

Example (3). C, a calendar year taxpayer, owns property X with 500,000 barrels of primary production to which income was attributable for 1975 and property Y with 200,000 barrels of primary production to which income was attributable for 1975. Property Y has been transferred to C on January 1, 1975, on which date it was a proven property. Therefore, the exemption under section 613A(c)(1) does not apply to C with respect to production from property Y. C's average daily production for 1975 was 1369.86 barrels (500,000 barrels divided by 365 days) which did not take into account the nondepletable production from property Y.

Example (4). In 1975, D received his annual payment of the recoupable advanced royalty of $100*x* in connection with oil property. Later in 1975, $60*x* (of the $100*x* advanced royalty) was recovered from production from the property. In 1976, D received another advanced royalty payment of $100*x*. Later in 1976, $140*x* ($40*x* of the $100*x* advance royalty received in 1976) was recouped from production from the property. Neither advanced royalty payment was attributable to production in excess of D's depletable oil quantity. D is entitled to percentage depletion for 1975 only with respect to $60*x* of the advanced royalty received

$$(100x \text{ dollars } X \frac{\$\ 60) D}{\$100x)}$$

is entitled to percentage depletion for 1976 with respect to the $100*x* received in 1976. With re-

spect to the $40x$ received in 1975 not attributable to production in 1975, D is not entitled to percentage depletion for any year. Of course, D is entitled in 1975 to determine the allowable cost depletion with respect to the entire $100x$ received in 1975.

Example (5). In 1975, E leased an oil property to F, receiving a lease bonus. With respect to the lease bonus, E is entitled to take cost depletion but not percentage depletion.

Example (6). G owns an oil property with producing wells X and Y on it. G converts well X into an injection well. Prior to the application of the secondary process, it is estimated that without such application the annual production from well X would have been $50x$ barrels of oil and from Y would have been $100x$ barrels of oil. For the taxable year in which injection is commenced production from well X is $10x$ barrels and from well Y is $180x$ barrels. Forty x barrels of oil [$190x$ barrels of oil (actual production from the property)—$150x$ barrels (estimate of primary production from the property)] qualifies as secondary production.

Example (7). H, a calendar year taxpayer, owns a domestic oil well which produced 100,000 barrels of oil in 1975. The proceeds from the sale of 15,000 barrels of that production are not includible in H's income until 1976. The 15,000 barrels produced in 1975 are included in H's average daily production for 1976 and excluded from such production for 1975.

(b) ***Phase-out table.*** For purposes of section 613A(c)(3)(A)(i) and § 1.613A-7(h)(i) (relating to depletable oil quantity)—

In the case of production during the calendar year:	Tentative quantity in barrel
1975	2,000
1976	1,800
1977	1,600
1978	1,400
1979	1,200
1980 and thereafter	1,000

(c) *Applicable percentage.* For purposes of section 613A(c)(1) and paragraph (a) of this section—

In the case of production during the calendar year:	Applicable percentage
1975	22
1976	22
1977	22
1978	22
1979	22
1980	22
1981	20
1982	18
1983	16
1984 and thereafter	15

* * * * *

§ 1.613A-7 *Definitions.* * * * * *

(f) *Average daily production.* (1) The term "average daily production" means the taxpayer's aggregate production of domestic crude oil or natural gas, as the case may be, which is produced after December 31, 1974 and to which gross income from the property is attributable during the taxable year divided by the number of days in such year. As used in the preceding sentence the term "taxpayer" includes a small business corporation as defined in section 1371 and the regulations thereunder. Notwithstanding the provisions of § 1.612-3 of this chapter, in computing the average daily production for a taxable year only oil or gas which has been produced by the close of such taxable year shall be taken into account. For example, advanced royalties (to the extent that actual production during the taxable year is insufficient to earn such royalties) and lease bonuses, while taken into account for purposes of sections 61 and 612 (relating to the

definition of gross income and cost depletion, respectively), would not be taken into account in computing the percentage depletion allowance pursuant to section 613A(c). Average daily production does not include production resulting from secondary or tertiary processes.

(2) In the case of a fiscal-year taxpayer, subparagraph (1) of this paragraph shall be applied separately to each short taxable year under section 613A(c)(10).

(3) In the case of a taxpayer holding a partial interest in the production from any property (including an interest of a partner in property of his partnership) such taxpayer's production shall be considered to be that amount of such production determined by multiplying the total production (which is produced after December 31, 1974, and to which gross income from the property is attributable during the taxable year) of such property by the taxpayer's percentage participation in the revenues from such property during such year. With respect to a holder of a net profits interest in an oil and gas property, such taxpayer's production shall be deemed to be that portion of production which produced the same fraction of the property's gross income as the fractional interest of the taxpayer in the net profits from the property.

* * * * *